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PROGRESSIVE ECONOMY

New Progressive Economic Perspectives

in the Central and Eastern European Member States of the EU

GKI Economic Research Co., Budapest

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Foreword

Hannes Swoboda, President of the Socialists and Democrats in the European Parliament

Dear Reader,

I am delighted to present you this new study entitled New Progressive Economic Perspectives in the Central and Eastern European Member States of the EU, produced by the well-known Hungarian economic research institute GKI Co. in Budapest. The study aims at opening a genuine debate on the economic and social alternatives in the countries of Central and Eastern Europe.

First of all, this study seeks to fill a gap generated by the focus put on the eurozone in recent debates to the detriment of the necessary scientific and political attention to be granted to the particular economic and social situations among Central and Eastern European countries, especially during this crisis.

Secondly, the study provides us with extremely useful analysis and, above all, clear policy recommendations. It recommends that there should be more integration in terms of fiscal union with joint efforts to decrease government debt (including the pooling of debt) as well as stronger tools to create investment, growth and the jobs of tomorrow. It furthermore insists that the catching-up process of these Member States needs to be speeded up. It shows, for example, that joining the EMU would be very beneficial to both the EU and all of the 11 countries which have joined post-2004, and even suggests introducing more flexibility in the accession criteria. Finally, it argues that the EU needs to move towards a social union with a stronger EU budget alleviating child poverty, homelessness and social exclusion.

The study is subject to a first public debate involving experts and policymakers from across the region and from other parts of Europe on 4 October 2013 in Budapest, at a major Progressive Economy conference.

I hope that this will help to generate a stronger focus on the region, with the ultimate aim of speeding up its economic and social development within a more prosperous and fair European Union.

Hannes Swoboda
President of the Socialists and Democrats in the European Parliament

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INTRODUCTION

The objective of this report is **to analyse the effects of the global financial and economic crisis on eleven Central and Eastern European (CEE11) EU member states as well as the major features of their crisis management**. In this context **policy conclusions** will be drawn that may be instructive for elaborating progressive economic perspectives and devising strategies for the CEE11 EU member countries (and maybe not only for them).

We divided the CEE11 member countries of the EU into **three groups** for analytical purposes. The first group consists of the four **Visegrad** plus one countries, later **V5**: the **Czech Republic, Hungary, Poland, Slovakia plus Slovenia.** Apart from the fact that they all became members in the first round of EU enlargement in 2004, these countries share a common historical heritage and started multilateral economic and political cooperation among themselves in the early 1990s, following the transition to market economy and Western type parliamentary democracy. The second group is formed by the **Balkan3** countries, with **Bulgaria, Romania** and **Croatia**. Bulgaria and Romania acceded to the EU in 2007, Croatia in mid-2013. (The statistical data for Croatia are missing in some comparisons.) Apart from the geographical location and common historical past, their economic development level is far behind the EU average. Finally the third group includes the **Baltic countries (Estonia, Latvia and Lithuania – the Baltic3)**. In addition to their common historical roots, these countries gained independence after the collapse of the Soviet Union in the early 1990s.

We compare their performance with **each other**, to the **EU average**, the countries of the **EU periphery** EAP6 (Cyprus, Greece, Spain, Ireland, Italy, Portugal) that are now in a difficult situation, and to the **core countries** of the euro-zone EACORE (Austria, Belgium, Germany, Finland, France, Luxemburg, the Netherlands).

Slovenia, **Slovakia** and **Estonia** are members of the Economic and Monetary Union (EMU), **Latvia** will join it as of 1 January 2014. **Currency board agreement** (CBA) is maintained by Bulgaria, quasi CBAs by Lithuania and Croatia. Poland and Hungary apply **free floating**, whereas the exchange rate regime of the Czech Republic and Romania is characterized by **managed floating,** giving more flexibility to exchange rate policy in these countries.

As far as the time horizon of the report's statistical data is concerned, it ranges from 2003 to 2012. In general, averages were calculated from statistical figures for the pre-crisis period of 2003-2007 and from those of the crisis-hit period of 2008-2012 to compare the individual countries. **Different forecasts** were also prepared or used for the following years or decades. The CEE11 and the country subgroup averages were calculated without using weights (also because it better reflects the average country situation, as Poland is too big among CEE11).

As far as the **structure of the report** is concerned, **in the first part the impact of the crisis on the economy** is identified, **the reactions of economic policies** (also including EU level reactions) to the crisis are analysed and **the similarities and differences of crisis management** are defined. The **second** part analyses in detail the **equilibrium problems** of the CEE11 **and their perspectives, focusing on the general government debt (and budget deficit) issue.** The **third** part briefly presents the consequences of the crisis on the **banking system.** The **fourth** part summarises the effects of all these on the **labour market**, **social and welfare relations**. In the **fifth** part **growth and convergence perspectives** are analysed and the **sixth** part **summarises** the most important **results** and **conclusions including policy recommendations for the most important changes**.

1. Economic and social realities in the CEE11

1.1. Impact of the global financial and economic crisis

In this chapter the most important economic and social trends of the CEE11 countries are presented in a comprehensive way. Certain issues such as budget equilibrium, GDP growth and social situation are dealt with in detail in some of the subsequent chapters.

The global financial and economic crisis **started in late summer 2007** in the sub-prime real estate market of the US and spilled over to the real economy. It led to a sovereign debt crisis in 2009, which has not been overcome yet in general and in the EU and the EMU in particular. **Recession** took place on an annual basis in 2009 and 2012 (and is likely to continue in 2013) in the EU and the EMU and in 2008 and 2009 in the US.

The CEE11 countries were relatively resilient to the crisis **until September 2008,** when the US investment bank Lehman Brothers collapsed. The reason for this was that banks in CEE countries did not have toxic financial assets in their portfolio. After the default of Lehman Brothers the global financial and economic crisis intensified.

The major reasons why CEE11 countries were seriously affected by the global crisis included **dependence on external financing**, the **high role of export in their economies** and **the existing macroeconomic imbalances**. Increasing risk aversion of foreign investors generally and especially towards the region, the contraction of external demand and deleveraging by financial institutions had a more adverse impact on the CEE11 economies, than on the developed industrial ones. (It is important to note that in historic terms the CEE11 countries had set to integrate into the EU in the late 1980s and early 1990s and simultaneously to this, the convergence to the development level, inter alia, in terms of per capita GDP of the EU started, their dependence on external sources and their rather huge imbalances were a **natural consequence** of this process.) Otherwise, the **substantially lower level of public debt relative to GDP of** the CEE11 countries compared to the EU average was an important advantage for them.

As far as the impact of the crisis is concerned, **Poland was the single country,** not only in the CEE11 but in the EU as well, that has recorded positive **GDP growth rates** in each year since 2008. Nevertheless, its annual average rate of growth decelerated from 5.6 per cent in 2003-2007 to 3.4 per cent in 2008-2012. In spite of the **sharp contraction** in 2009, Bulgaria and Romania reached slightly positive annual average growth rates later, Slovakia even a more robust one. The first contraction of GDP was roughly the same in the Czech Republic, Hungary and Slovenia, but in these countries recession took place not only in 2009 but in 2012 as well. On the other hand, in the **Baltic3** recession started in early 2008, well before the collapse of the Lehman Brothers and they suffered double-digit fall of GDP in 2009. Nonetheless, they rebounded quite quickly in the subsequent years, although their GDP has not reached pre-crisis levels. Before the crisis the Baltic3 grew rapidly, even at unsustainable rates, their economies were overheated; this was not the case in most of the other CEE11 countries except Bulgaria and Romania. (After having gained independence from the Soviet Union, the Baltic3 lost half of their GDP, the rapid growth thereafter made up for these losses.) The recession was more prolonged and thereby deeper in Croatia than in rest of the CEE11 region.

As a summary it may be stated that in the period between **2008 and 2012 the annual average performance of the CEE11 countries was rather close to the EU average. GDP** declined by 0.1 per cent annually in both group of countries. I**nvestments** fell by 2.6 per cent in the CEE11 against 3.1 per

cent in the EU, **household consumption** by 0.6 per cent against 0.1 per cent, and **government consumption increased** by 0.5 per cent against 1 per cent. In comparison with the EAP6 countries, the performance of the CEE11 countries was substantially better. Cross-country **cyclical differences were quite considerable compared to the euro area** member states before the crisis and they **intensified afterwards**. In addition, not only the impact varied across countries, but the timing and the speed at which countries were affected by the crisis as well.[1]

Before the global financial and economic crisis (from 2003 to 2007) the **convergence** process of the CEE region in terms of GDP growth was **remarkable**. The rate of GDP growth exceeded the EU average in every CEE11 country. From 2008 to 2012 the **convergence process came to a halt in** the **Baltic countries**, **Croatia**, **Slovenia** and **Hungary**. It slowed down significantly in the rest of the CEE11 with the **exception of Poland** where it continued at the same speed. Between 2008 and 2012 Poland's GDP grew by 17 per cent, whereas that of the EU fell by 0.6 per cent. **In the six euro-zone member countries most affected by the crisis – EAP6 – GDP fell by 1.5 per cent annually, more than in the CEE11 countries.**

GDP, investment, private and government consumption in the CEE11
(Annual average volume change in per cent)

	GDP		Investment		Private consumption		Government consumption	
	2003-2007	**2008-2012**	**2003-2007**	**2008-2012**	**2003-2007**	**2008-2012**	**2003-2007**	**2008-2012**
Czech Republic	5.6	0.3	5.6	-1.7	4.0	0.2	0.8	0.3
Hungary	3.3	-0.9	2.8	-5.0	3.0	-2.2	1.0	-0.3
Poland	5.2	3.4	8.9	3.1	3.7	2.8	4.6	2.4
Slovenia	4.8	-1.0	7.8	-0.3	3.5	0.3	2.7	1.4
Slovakia	7.0	1.2	7.4	-0.3	5.1	0.9	2.8	1.7
V5	**5.2**	**0.6**	**6.5**	**-0.8**	**3.9**	**0.4**	**2.4**	**1.1**
Bulgaria	6.3	0.7	16.3	-4.0	7.8	0.0	3.2	-1.1
Croatia	4.8	-2.0	10.4	-6.3	4.3	-2.0	3.5	-0.7
Romania	6.4	0.5	16.8	-0.4	11.7	0.2	-0.1	1.5
Balkan3	**5.8**	**-0.3**	**14.5**	**-3.6**	**8.0**	**-0.6**	**2.3**	**-0.1**
Estonia	8.1	-0.7	13.9	-2.5	5.4	-1.8	4.4	1.5
Latvia	9.5	-2.2	16.6	-5.8	12.6	-3.2	3.2	-0.3
Lithuania	8.6	-0.2	16.2	-5.4	11.1	-1.5	2.8	-0.7
Baltic3	**8.7**	**-1,0**	**15.6**	**-4.6**	**9.7**	**-2.2**	**3.5**	**0.2**
CEE11	**6.3**	**-0.1**	**11.2**	**-2.6**	**6.6**	**-0.6**	**2.6**	**0.5**
Memorandum								
EU	**2.5**	**-0.1**	**4.0**	**-3.1**	**2.1**	**-0.1**	**1.9**	**1.0**
EAP6	**3.2**	**-1.5**	**5.1**	**-10.1**	**3.5**	**-1.6**	**2.9**	**-0.6**
EACORE	**2.8**	**0.0**	**3.9**	**-0.6**	**1.6**	**0.6**	**1.8**	**1.6**

Note: The figures of the individual country groups (except the EU) are un-weighted averages.
Source: Eurostat

The crisis hit the individual elements of GDP **differently** in the CEE11. It was only **Poland** where both **investment,** as well as **private and government consumption went up** between 2008 and 2012, in line with GDP growth. The **contraction of investment was more substantial** than that of **private and government consumption** in the rest of the CEE11, particularly in Hungary, Croatia, Bulgaria and the

[1] ECB Monthly Bulletin (2010)

Baltic countries. In the EU, too, the fall of investment bore the lion's share of adjustment rather than private and government consumption. **The contraction of investments was particularly robust – 10 per cent per year – in the EAP6 countries, exceeding 14 per cent annually in Ireland and Greece! Private consumption increased** only in **Poland** and slightly in **Slovakia**. **Some** CEE countries (Slovenia, the Czech Republic, Romania and Bulgaria) **stagnated**, but most of them recorded **substantial decline:** it contracted by 2-3 per cent per annum in the Baltic3 and 2 per cent in Hungary and Croatia. **Consumption dropped by 10 per cent in these countries from 2008 to 2012, creating extreme difficulties in social sphere. Similar trends unfolded in the EAP6 countries**, whereas private consumption grew on the average by 0.5 per cent per annum in the **EACORE** countries, with a very slight decline in the Netherlands only. **Only some** governments in the CEE11 (Poland, Slovakia, Slovenia, Romania and Estonia) used the increase of **government consumption** expenditure as an essential anti-crisis or in other words **demand-stimulating instrument.**[2] In contrast to this in countries such as Bulgaria and to some extent Latvia, Lithuania, Croatia and Hungary, **government consumption decreased in the past years**.

During the crisis, **export growth rates** as well, **slowed down** due primarily to the contraction of external demand in 2008-2012 compared to the previous period of 2003-2007.(The crisis started with the drop of the export, but later rebound was seen.) Nevertheless, with the exception of Croatia and Slovenia, export growth in the CEE11 countries exceeded the EU average. The further expansion of exports was impeded by relatively high inflation rates, as well as by increasing unit labour costs in euro area member states (Slovakia, Slovenia and Estonia), creating a loosening in competitiveness, or in countries with pegged exchange rate regimes (Latvia, Lithuania, Bulgaria and Croatia) by the real appreciation of the national currencies. In spite of that, some of these countries, such as **Lithuania** and **Estonia** reached **quite high export dynamics** from 2008 to 2012.

On the other hand, as a consequence of sluggish GDP growth, the rate of increase of **imports slowed down more than that of exports**, or imports even declined in Croatia, Latvia, Slovenia and Bulgaria in the same time frame. As a result, **the deficit of merchandise trade** decreased, particularly in the Baltic3, Bulgaria and Croatia, and in some countries, such as Hungary and Slovakia, the trade deficit turned into surplus, or increased further, like in the Czech Republic. With the different growth rates of exports and imports, **net exports mounted constituting an important contributing factor to GDP growth**. Since Poland is a relatively closed economy in terms of the share of exports and imports in GDP, the contraction of external demand had a smaller impact on Polish GDP growth.

[2] Kazimierz Dymarszki (2010)

Exports and imports, merchandise trade and current account balance in the CEE11

	Exports		Imports		Merchandise trade balance in per cent of GDP		Current account balance in per cent of GDP	
	annual average change in per cent							
	2003-2007	2008-2012	2003-2007	2008-2012	2003-2007	2008-2012	2003-2007	2008-2012
Czech Republic	11.5	4.4	9.3	3.0	0.6	2.1	-3.8	-4.3
Hungary	13.2	3.6	11.6	1.7	-2.9	2.4	-8.2	-0.6
Poland	11.9	4.6	12.1	2.6	-2.4	-2.1	-3.3	-4.2
Slovenia	10.4	0.9	11.0	-1.4	-3.7	-3.0	-2.4	-0.8
Slovakia	13.6	4.8	11.0	2.4	-3.7	1.2	-7.1	-2.4
V5	**12.1**	**3.7**	**11.0**	**1.7**	**-2.4**	**0.1**	**-5.0**	**-2.5**
Bulgaria	10.3	3.7	14.7	-0.5	-19.3	-11.7	-13.3	-6.7
Croatia	6.0	-1.5	7.1	-4.2	-21.4	-16.0	-5.9	-3.1
Romania	9.8	4.5	20.8	1.5	-10.5	-11.7	-8.8	-5.7
Balkan3	**8.7**	**2.2**	**14.2**	**1.1**	**-17.1**	**-13.1**	**-9.3**	**-5.2**
Estonia	10.0	6.5	12.9	3.2	-15.9	-6.0	-12.9	-0.7
Latvia	10.2	3.9	16.0	-1.4	-21.4	-10.5	-15.7	-1.1
Lithuania	8.9	8.3	13.0	3.9	-12.0	-6.0	-9.3	-3.1
Baltic3	**9.7**	**6.2**	**14.0**	**1.9**	**-16.4**	**-7.5**	**-12.6**	**-1.6**
CEE11	**10.5**	**4.0**	**12.7**	**1.6**	**-10.2**	**-5.6**	**-8.2**	**-3.0**
Memorandum								
EU	**6.2**	**1.9**	**6.5**	**0.6**	**-0.1**	**-0.4**	**0.0**	**0.0**
EAP6	**5.1**	**0.5**	**6.2**	**-3.7**	**-6.2**	**-4.3**	**-5.9**	**-5.8**
EACORE	**6.2**	**1.3**	**6.4**	**1.6**	**1.7**	**-0.1**	**4.6**	**3.1**

Note: The figures of the individual country groups (except the EU) are un-weighted averages.
Source: Eurostat

Before the global financial and economic crisis, the CEE11 average **current account** deficit was 8.2 % of the GDP, the Baltic3, Bulgaria, Romania, Hungary and Slovakia reached high levels. The FDI and the slowly increasing EU funds participated in the financing of the CA deficit, but it raised the external debt of the countries as well. With high level of external indebtedness and financing needs, CEE11 countries were exposed to vulnerabilities in terms of changes in investor confidence. In fact, the **CEE11 suffered a public finance crisis combined with a partial current account crisis, in contrast to the EAP6 states that had basically a public finance one. The adjustment in the current account from 2008 to 2012 was remarkable in the CEE11, most outstanding in the Baltic3, Bulgaria, Hungary and Slovakia. Due to the growing EU funds inflow the capital plus current account improved even more.** The CEE11 region radically reduced its external financial exposure, **in contrast to either the EAP6 or the EACORE**. The current account deficit of EAP6 totalled **more or less** a permanent 6 per cent of GDP. EACORE recorded a current account surplus amounting to 3-4 per cent of GDP. (This does not constitute a problem for the euro-zone, but has implications for competitiveness in the group.)

Domestic savings were not sufficient to cover the demand for credit. **Economic growth in the CEE11 countries was based largely on external financing in terms of bank loans, trade related lending and foreign direct investments (FDI) that constituted at the same time vulnerability to external shocks** in crisis situations where capital inflows stop suddenly.[3] Very low and sometimes negative real interest rates led to **credit and real estate bubbles**. In fact, at the peak of the financial crisis in late 2008 and early 2009, credit default swap (CDS) spreads jumped, which led to the **downgrading of**

[3] Béla Galgóczi (2009)

government debts by international rating agencies, and **devaluation pressure** intensified in these countries surveyed because of external shocks.

More than 80 per cent of the banks in the CEE11 are **affiliates of Western banks**. Based on the financial sources obtained from their mother banks, foreign affiliates before the crisis were in the position of offering both households and the corporate sector **cheap credit denominated in foreign currencies** (primarily in Swiss Franc and euro), **in countries where interest rates in local currencies were much higher**. In some CEE11 countries domestic banks followed suit. The residential mortgage debt relative to GDP varied between 11.7 per cent in Poland and 15.3 per cent in the Czech Republic on one hand, and over 30 per cent in the Baltic3 countries on the other hand.[4] (These numbers are low by EU standards.) From a different point of view, in 2008 over $250 billion of loans (or roughly 40 per cent of total loans outstanding) in Central and Eastern Europe were denominated in foreign currency. Foreign currency borrowing was much more significant among households than among firms. **Not FX lending is a problem, but the credit bubble deriving from it**. Many families took advantage of the cheap credit source, even those whose income situation was uncertain, thus after the brake-out of the crisis, they fell into a difficult trap.

Due to the high volume of FX loans a **significant depreciation of the local currency could endanger financial stability** in these countries. With the accession to the euro-zone and the introduction of the euro before the crisis this threat **disappeared** in Slovakia and Slovenia, later in Estonia. In spite of the strong pressure, devaluation was avoided in many countries with pegged exchange rates.

Prior to the crisis employment was rather weak in the CEE11. During the crisis **it decreased more rapidly** than GDP, and in countries with positive GDP growth rates its rate of increase was lower than that of the GDP. (Until 2012 employment did not drop in Poland, Slovakia and the Czech Republic.) **Employment** in the CEE11 fell to a greater extent on the average than in the EU, but less than in the EAP6. The **loss of jobs** and the concomitant **increase of the unemployment** rate were **dramatic in the Baltic3 and in Hungary**. In addition, emigration picked up as well. E.g., as far as **Latvia** is concerned, some 200 thousand people amounting to **10 per cent of total population** left the country. On the other hand unemployment rate fell substantially in Poland, Slovakia, the Czech Republic and Bulgaria. The average **unemployment** rate in the V5 and the Balkan3 countries decreased slightly in 2008-2012. in contrast to 2003-2007. In the Baltic3 it grew substantially. It is remarkable that the rate of unemployment was down in the EACORE, but it jumped in the EAP6 countries.

[4] Daniel Gros (2009)

GDP, employment and unemployment rate in the CEE11

	GDP		Employment		Unemployment rate	
	annual average change in per cent				per cent	
	2003-2007	2008-2012	2003-2007	2008-2012	2003-2007	2008-2012
Czech Republic	5.6	0.3	0.9	0.0	7.3	6.4
Hungary	3.3	-0.9	0.0	-0.6	6.8	10.2
Poland	5.2	3.4	1.9	1.2	16.1	8.9
Slovenia	4.8	-1.0	0.9	-0.9	6.1	6.9
Slovakia	7.0	1.2	1.3	0.3	15.4	12.8
V5	**5.2**	**0.6**	**1.0**	**0.0**	**10.3**	**9.0**
Bulgaria	6.3	0.7	3.0	-2.5	10.4	9.3
Croatia	4.8	-2.0	2.7	-2.4	12.2	11.7
Romania	6.4	0.5	-0.4	-0.3	7.1	6.9
Balkan3	**5.8**	**-0.3**	**-1.8**	**-1.7**	**9.9**	**9.3**
Estonia	8.1	-0.7	1.9	-1.1	7.6	11.8
Latvia	9.5	-2.2	2.6	-4.5	9.2	15.4
Lithuania	8.6	-0.2	1.9	-1.8	8.1	13.1
Baltic3	**8.7**	**-1.0**	**2.1**	**-2.5**	**8.3**	**13.4**
CEE11	**6.3**	**-0.1**	**1.5**	**-1.1**	**9.7**	**10.3**
Memorandum						
EU	**2.5**	**-0.1**	**1.0**	**-0.3**	**8.6**	**9.2**
EAP6	**3.2**	**-1.5**	**2.3**	**-2.0**	**7.3**	**12.2**
EACORE	**2.8**	**0.0**	**1.1**	**0.8**	**7.0**	**6.4**

Note: The figures of the individual country groups (except the EU) are un-weighted averages.
Source: Eurostat

1.2. Reaction of economic policies

In the wake of the crisis, **Latvia, Hungary and Romania** applied soon for **financial assistance** from the consortium of the **EU and the IMF,** although primarily because of difficulties in external financing of the public debt, but with implications for the general country debt financing as well. This fact determined the reactions of **fiscal policies** in these countries. **Poland** (alone in the region) obtained access to the **flexible credit line of the IMF** for financial safety but in practice **it was not used at all**. The EMU member countries were able to rely on the financing of the ECB as well.

Nearly all countries fall under EDP as the crisis situation increased dramatically the budget deficits. The fiscal consolidation was painful. (The second part of the report analyses the budget equilibrium in details.)

The autonomy of **monetary policy** in countries with **pegged exchange rate regimes** (the Baltic2 countries, Bulgaria and Croatia) **was rather limited**. In order to maintain the fix or quasi fixed exchange rate regimes **central bank reference rates were raised** in these countries in spite of falling inflation. This was not in line with the monetary policy stance of the European Central Bank that reduced its reference rate. **Some countries with pegged exchange rate or with euro, as national currency** could only adapt to the situation with **internal devaluation**.

The **availability** of independent exchange rate policy (in non-euro zone countries) is not equal to the **liberty** of the exchange rate policy. Furthermore, the **liberty** of the exchange rate policy is not equal to any notion of **efficiency**. For example, in several countries with independent currency independent

exchange rate policy can be pursued, but **if foreign debt is high and/or the indebtedness of domestic economic actors in foreign currencies is high**, then this may imply a very **strict constraint** to exchange rate policy because of the risk of a current account crisis. This holds true for **Hungary**, and to a smaller extent for **Poland**. The currencies of these countries **depreciated** moderately, by about 10-15 per cent during the crisis. In contrast to this, the **Romanian** currency depreciated steadily and significantly (by more than 30 per cent), whereas the **Czech** currency, on the contrary, **appreciated**. Which was more efficient? The growth rate of exports in the four countries was practically identical, totalling 3.6-4.6 per cent annually between 2008 and 2012, whereas the growth rate of imports varied between 1.5 per cent and 3 per cent. No important difference!

In **Hungary**, the **unconventional** or **unorthodox economic policy** of the government (including the nationalisation of the assets of private pension funds, the heavy taxation of sectors such as financial intermediation, energy, telecommunications, retail trade with a negative bias to companies with foreign participation, retroactive legislation, etc.) **has not been compatible with market economy principles** and **has not involved the true reform of the general government**. The **lack of ideas** of governments in the region is demonstrated by the fact that several countries decided to **copy** these measures that **had a dramatically adverse impact on the business climate** in Hungary. (Such a **bad example** is the most recent Polish **counter-reform of the pension system** that, of course, also reflects how narrow minded EU institutions were when they did not allow the inclusion of the effects of the pension reforms in the general government in these countries 15 years ago. This is how positive structural reforms are left without room of manoeuvring, and at the end are strangled, because of their temporary negative fiscal effects.)

Western European banks in 2009 made a commitment to provide their CEE affiliates with liquidity during the crisis when the latter units could not get access to financial sources at reasonable prices thereby trying to maintain the pre-crisis level of credits. In turn, the CEE-governments concerned made commitments not to impose extra burdens on these affiliates. This agreement was broken by the governments in several countries (primarily in Hungary), and the banks discontinued the Vienna Initiative agreement later. In this respect countries with a high share of foreign banks were better off than those with the dominance of indigenous ones, part of which were state-owned (Slovenia). In the latter group of countries it was governments that had to rescue/recapitalise bad banks rather than the mother companies. In fact, that is the **most important source of budgetary problems recently in Slovenia**.

1.3. Similarities and differences in crisis management

In the wake of the crisis, CEE11 countries were hit by the same external shocks. With **differences in their economic structures, institutional systems** and the **state of their economies** prior to the global crisis, these shocks proved to be asymmetrical in nature, implying that although these were the same shocks, they affected the countries concerned differently in terms of GDP growth, internal and external disequilibria, economic policies, exchange rate regimes, etc. This implies that the individual **country groups** surveyed (V5, Balkan3 and Baltic3) **did not prove to be homogenous**, on the contrary, their **specific features dominated** rather than their common characteristics. **Divergence, rather than convergence was the main trend.**

Before the accession to the EU, a political consensus prevailed in the CEE region on meeting the preconditions of EU membership. After the enlargement of the EU this **consensus faded away slowly** and the **internal political problems came to the surface with pronounced economic implications**. This **trend intensified during the crisis**. The political landscape was rather diverse, in some countries

supporting crisis management, in other ones inhibiting it. In the **Czech Republic** the liberalised economy with significant foreign participation in terms of a huge stock of foreign direct investments withstood to a certain extent the potential negative impacts of shaky governments. The situation was more or less similar in **Slovakia**. In the **Baltic countries** governments with a tight parliamentary majority carried out remarkable adjustments and reforms. In **Hungary**, although the present government possesses a two third majority in parliament, it has used its legislative and executive power to pursue an unorthodox economic policy contradicting to the rules of mainstream economics. **Bulgaria** is a special case since its democratic political system is in ruins. Political dividedness is rather strong in **Romania** as well.

As far as the impacts are concerned, **first**, the **most overheated countries with significant imbalances,** such as the **Baltic countries** and to a lesser extent **Bulgaria** and **Romania,** were influenced the most adversely by the crisis. **Second**, the effects of the crisis were different across countries depending on **structural openness**. The contraction of external demand hit the small Baltic countries with **high export shares** in GDP the most, on one hand, whereas its impact on **Poland,** the best performer in the region, with a rather large internal market, was much less significant. On the other hand, the expansion of exports, more precisely the **increase of net exports,** contributed later to the rebounding of GDP to an outstanding extent. Due to orders of magnitude, this could not have been possible for larger countries because of limits in the size of external demand. Obviously, the **depreciation of the national currency was not a precondition** of restoring the competitiveness of exports (at least in terms of cost competitiveness); there were other tools as well.

Third, monetary policy and the associated exchange rate regime also mattered. The major dividing line was between countries using **fixed exchange** rate regimes, as members of the EMU, such as **Slovenia, Slovakia** and **Estonia,** or some forms of CBA, such as Bulgaria, Croatia, Latvia and Lithuania **on one hand,** and those having maintained some kind of **floating exchange rate** regimes, such as Poland, Hungary, the Czech Republic, and Romania **on the other one**.

Countries with definite signs of overheating and imbalances **suffered deeper recession, higher unemployment** and **general government deficits.** Nevertheless, **recovery after the 2009 recession**, as well, **was remarkable** in these countries. In addition to fiscal consolidation, they were **forced to undertake more structural reforms**. CEE countries in the euro-zone (Estonia, Slovakia and Slovenia) got **access to the liquidity of the ECB**, therefore they were under weaker pressure to introduce structural reforms. The **austerity measures introduced by the Baltic countries were so severe** that even the **IMF and European Commission criticised them**. In fact, the economic policy based on austerity was accepted by the population **without major opposition**. Obviously, a **social consensus emerged** on this issue.

In fact, the **relationship** between the **exchange rate regime** and **GDP growth is rather mixed**. Countries with both **fixed and flexible exchange rate regimes achieved rather favourable GDP growth** rates from 2008 to 2012. Such were **Slovakia, Bulgaria, Estonia** and **Lithuania** on one hand and **Poland, Czech Republic** and **Romania** on the other one. **In other words, neither the euro-zone membership or the fixed exchange rate regime nor the flexible one was a guarantee for dynamic GDP growth. Other factors** must have played a role in it as well.

Countries with pegged exchange rate regimes did not devalue their currencies in spite of the fact that they had the largest current account deficits. Economic policy decision makers may have come to the conclusion that **nominal devaluation may produce more harm than good**. In the absence of nominal devaluation, the burdens of adjustment were borne by the real economic sphere. Adjustment took place

through **internal devaluation instead of external or nominal one**, i.e. by the reduction of prices, wages, employment and the introduction of fiscal austerity including cuts in social transfers and other welfare expenditures, etc. **This policy involved huge social costs hardly bearable elsewhere. The Baltic countries chose this path more or less uniformly.** Their extremely rapid development in the previous years, their strong migration oriented abroad, as well as the denial of rights to a part of the societies, all contributed to their success.

Floating exchange rate regimes proved to be a more flexible economic policy tool in the crisis. The nominal (external) depreciation of the national currency served as a buffer between the external environment and the domestic economy. The flexible exchange rate regime **could not necessarily compensate** for the high foreign financed public debt in 2008 and for the unorthodox or unconventional economic policy that has been pursued by the Hungarian government since May 2010, diverging from mainstream trends. The **positive example is Poland** with its successful adjustment based on its floating exchange rate regime allowing a moderate depreciation of the national currency that bolstered exports. The **Czech Republic**, too, coped with the crisis **rather successfully**, but this was **not the case in Romania**. It is remarkable that Romania was not successful **even with steady and significant depreciation**. The Czech currency depreciated by about 5 per cent in 2009. However, since then the Czech crown has been appreciating mildly. In spite of the diverse exchange rate movements the Czech economy is rather successful. **Free exchange rate policy does not guarantee success.**

The effects of the crisis were different over the CEE11 in respect to the relative importance of **loans denominated in foreign currency**. These loans expanded in almost all countries in the region (even in Austria), especially in Swiss francs, however, **their importance was the largest in Hungary**. The significant volume of FX loans, which is actually a credit bubble that has a huge effect on construction and the real estate market, was a **limiting factor to economic policy** in general and to exchange rate policy in particular. The CEE countries whose monetary, fiscal and supervisory authorities limited the diffusion of FX credits (Poland, Czech Republic) were certainly better off than the other ones. Countries with **a high share of FX loans were not in the position to abandon the pegged exchange rate** or **allow the significant devaluation of their national currencies without endangering financial stability**.

Foreign ownership of banks, too, proved to be an asset during the crisis, since they provided the CEE11 (Baltic3, Hungary) with the necessary liquidity that was missing otherwise. On the other hand, **in Slovenia where the banking system has not been privatised yet, the recapitalisation of financial institutions had to be financed by public money** with adverse consequences on the general government balance. Although the relative share of foreign banks was rather modest in Poland, as a result of prudent supervision the financial sector remained stable during global turbulences.

With the global financial and economic crisis **the convergence process** of the CEE region in terms of GDP growth rates and per capita GDP stopped. Between 2008 and 2012 the **CEE11 countries** recorded a **drop in GDP by 0.1 per cent per annum that was equal to that of the EU average, but without Poland the CEE10 drop per annum was higher, 0.5 %.** Within the V5 group, Poland, Slovakia and to a certain extent the Czech Republic converged, whereas Slovenia and Hungary lagged behind. From among the Balkan3 countries Croatia fell back considerably, Bulgaria and Romania converged to a certain extent; and the Baltic3 countries fell back, especially Latvia (but it should be noted that the Baltic countries are on a path of dynamic GDP growth). The **relatively good Polish** performance could be attributed to a large extent to a specific factor, namely the **size of the domestic market**. **The price of good performance was the increase in general government deficit and government debt. There is reason to assume that with the given form of crisis management**

(nationalisation of private pension funds) and the postponement of structural reforms, Poland is ahead of painful adjustments in the near future.

The global financial and economic crisis **questioned the viability of the former growth model** of **the CEE11 based on excessively strong credit growth financed externally and rising property and asset prices**. Slower credit growth as a consequence of **deleveraging** may constitute a limiting factor to GDP growth. This can be neutralised to some extent by promoting the savings of households and the inflow of foreign direct investments if accommodative incentives are at work.

As far as the **generalisation of experiences** is concerned, at first glance it seems that **the same results in terms of GDP growth, internal and external equilibrium, etc. can be achieved by the deployment of totally different economic policies**.

- The policy pursued by the **Baltic countries**, which was determined by the **pegged exchange** rate regime and **sharp internal devaluation**, produced a **controversial success story** rooted in the **specific circumstances** of the region. **This is not viable elsewhere!** The social and political consensus that was brought about in these countries concerning the maintenance of the pegged exchange rate regime **and** the severe fiscal austerity associated with it could be explained by **historic roots** in terms of fears of Soviet domination and therefore **this model is inconceivable in other EU member states**.

- **Less painful austerity** was deployed by the **CEE11 countries in euro-zone**. It worked best in Slovakia, presumably because of the structural reforms implemented prior to the global financial and economic crisis.

- As far as countries with flexible exchange rate regimes are concerned, the **relative success story of Poland is closely related to a specific feature, namely the rather large size of the economy**. The **large domestic** market compensated for the contraction of external demand. Nevertheless, growing imbalances indicate that some problems were postponed over time.

- The common currency **clearly proved to be advantageous** for the affected EMU countries **before the global financial crisis** and **in the first period of the crisis**: it increased trust among investors, accelerated investments, and in the beginning of the crisis **protected** the countries from a rapid balance of payments crisis. However, as soon as the euro zone fell into the focus of the financial crisis, the **market rated the countries of the currency union individually**.

- A lesson from the euro crisis is, that b**efore a country gives up forever the possibility of correcting its macroeconomic equilibrium by way of the currency exchange rate, it shall develop the mechanisms, which may prevent the evolution of processes that would make it necessary to change the exchange rate.**

The major general conclusion may be that successful crisis management depended on:

- **coherent economic policies aiming at the consolidation of the general government in the short-term,**
- **structural reforms and improvement in competitiveness in the long-run, that fit well in the specific economic and political conditions of the individual CEE countries,**
- **keeping as much as possible the social cohesion of the society.**

2. Equilibrium problems

2.1. Situation and relative position of the CEE11

One of the greatest long lasting economic problems of the EU is the rather high and still growing general government debt to GDP ratio, which hinders the growth as well.

According to the data of the EU Spring 2013 Economic Forecast, **the EU average** gross government **debt** to GDP **rate increases** from the 2008 pre-crisis 62% level, to slightly **above 90% in 2014**. **The countries' average** (that is the average of the member states data, not weighted with the debt and GDP of the individual countries), which better reflects the characteristic country situation **is at 74%**. Six EU countries reach an above 100% indebtedness level (but **none of them** belong to the now examined CEE11 countries).

Contrary to the original idea that euro-zone membership generates fiscal discipline, the euro-zone gross debt average is much higher than the non-euro zone countries' average! **In 2014 the euro-zone member countries'** (un-weighted) **average is close to 88%, while the non-euro zone countries' average data is only 48%**.

> It is **not fair** to say that the difference is only due to more responsible fiscal policies in non-euro countries. But it illustrates that the original (and still maintained) concept to create **very tough euro-zone entry exam conditions and procedures in order to guarantee the right policies during later membership did not work**. Tougher periodic exams are much more important than the rigorous fulfilment of all the existing criteria of the entry exam - spending precisely minimum two years in ERM-2 versus avoiding a 0.1% higher than required inflation.

The now examined CEE11 countries' average debt ratio is at 47% of the GDP, while even that of most indebted country among them, of Hungary, is only by 5 percentage points above the EU countries' (un-weighted) **74%** average. **This means that the high public debt ratio issue seems to be a smaller burden for the CEE11 countries, than for the EU as a whole.** (But some factors, as the relatively higher risk premium determined by the market, the lack of ECB participation in buying government bonds for non-euro zone countries, and others **are diminishing that advantage**).

The gross government debt ratio of the EU is still growing, but the 2014 estimate is only slightly above the 2013 forecast. There is a chance that the ratio may reach its peak soon. (A descending tendency is the hope for the following years, which is already the case with many member countries). It is clear from the tables on the following pages that high debt ratio level and increasing debt ratio problems are more and more **concentrated on certain countries**, mainly the so called programme countries, the EAP6. **The debt ratio changes of the CEE11 countries are similar to those in the EU landscape.** In 2014 a descending debt ratio tendency is expected for the Baltic countries, a near stagnating ratio for Romania and Hungary, and a still growing ratio for the other six countries. Among the countries with an indebtedness of above 60% debt to GDP, **Slovenia and Croatia are on a still rapidly growing debt ratio path**. But neither one of the CEE11 countries has accumulated unsustainable and un-financeable general government debt, not even Slovenia, where the debt ratio grew to the greatest extent between 2008-2012, by 32 percentage points.

General government gross debt
(ESA, as a percentage of GDP, un-weighted)

	2012	Deviation 2012-2008 in percentage points
V5	57.4	18
Balkan3	36.7	18
Baltic3	30.5	17
CEE11	44.4	18
EAP6	115.9	45
EACORE	70.0	14

Note: The figures of the individual groups are un-weighted averages
Source: Eurostat

2.2. Historical background

All the examined CEE11 countries (in many cases as parts of a later disintegrated larger country) were socialist countries a quarter of century ago**. Some of them were heavily indebted in the eighties, even at the beginning of the transition.** At that time, the foreign indebtedness typically meant high public (central government) debt as well. **Poland, Yugoslavia and Bulgaria went through debt rescheduling, and partial foreign loan write offs, while the also heavily indebted Hungary intended to, and was able to avoid such a scenario.**

For the majority of the examined CEE countries the political transition ended with an only modest public debt, the heritage was positive in this respect (for different historical reasons, as an exception to other aspects of the economy). But **Hungary, Poland and Bulgaria inherited high public (and foreign) debt**. In the case **of Poland a new wave of loan write off and rescheduling** eased the situation soon after the political change. **Bulgaria went through a major rescheduling in 1994. Hungary continued to insist on servicing the debt** according to obligations and also faced difficult situations.

The transition started with a very painful economic situation in the early 1990s. The decline in GDP was typically about 20%, employment diminished significantly, the banking sector nearly collapsed in many countries, as a lot of clients went bankrupt. All these painful developments contributed to the increase of the debt. In Hungary the central government debt ratio increased to nearly 90% by 1993. Poland also registered a more than 90% level of indebtedness. In the case of Bulgaria the debt ratio was above 100% even in 1997.

The ESA general government gross debt data are not available for 1990 (they have been calculated only for a limited time period backwards from the year these countries acquired EU membership). **In the case of Hungary the ESA debt ratio at the end of 1995 was 85.6% of the GDP**. **Poland,** after the rescheduling (and the partial write off) of its foreign (practically public) debt, following the shock therapy and the restarted growth, **was able to reach a 49% debt ratio** for the same year. At the end of **1999 Bulgaria had a 77.6%** ESA debt ratio.

The public debt situation of Poland, Hungary and Bulgaria in the nineties was somewhat similar to the present situation of many EU countries. The gross government debt ratio was also very high, one of the reasons was similarly **the significant drop of the GDP,** and the **banking sector crisis made high budgetary spending necessary**. That is why it might have some relevance to remember the success stories, especially the continuous adjustments implemented in Hungary and Bulgaria.

Hungary was able to go down from the about 85% debt ratio at the end of 1995 to 52.7% in 2001. The improvement was attained based on **massive privatisation revenues**, on **upfront significant fiscal tightening** (reaching at its highest level a 3.8% primary surplus in 1997), and on a 4**% yearly average real growth**, combined with a **sizable inflation** (6% yearly average GDP deflator). **Bulgaria was able to go down from a 77.6% debt ratio in 1999 to 13.7% in 2008.** The country reached **high primary surpluses** (in 2001 5.3%, while the average yearly primary surplus in the course of nine years was nearly 3%), and **high, nearly 6% average yearly GDP growth**, plus **sizable inflation** (a nearly 6.5% average GDP deflator) as well.

The main lessons from the above mentioned cases are as follows:

- **Impressive debt ratio decline is implementable only with relatively dynamic economic growth.** (Growth shall be export- and investment-led, but the affordable increase of consumption after initial budget adjustments helps the budget balancing.)

- **A sizable inflation might help to diminish the debt ratio.** It increases the nominal GDP and the tax revenues as well, even if the extra interest expenditures diminish the debt level gains. (But the latter is valid mainly with the newly issued national currency denominated bonds.) Of course **a modest inflation policy works only** if **competitiveness is maintained** (wage increases are contained, the price increases might even be concentrated in the non-tradable sector), and the **budgetary appropriations are not indexed.**

- **To reach an initial sizable primary budgetary surplus via expenditure cuts and revenue increases is painful, but unavoidable**. Later it can be politically relatively easier to maintain the initial adjustment, especially as growth picks up (but budgetary policy shall not use all the budgetary gains of the higher growth, only a part of them).

- Privatisation was a **one-off** element.

Nevertheless, each successful debt reduction programme had many special features, and **the creation of such a program needs smart national economic and budgetary policies and decisions, taking into account different effects.** From the three countries which were problem countries initially, Bulgaria was able to drop out from the category; Poland stabilized itself at a comfortable level, while **Hungary after the remarkable achievements made a negative turnaround.** From 2001 the governments initiated new oversized budgetary spending policies to please the electorate, which lead to a **new increase of the debt level to 67% by 2007.**

The initially low indebted countries within the CEE11 were generally able to maintain their positions, while in many cases modest increases occurred in numbers. In 1995 the debt ratios of all Baltic countries were below 20%, Romania's was even below 10%, while Slovakia with a 22% figure had the fourth highest debt figure. In 2003-2007 the Baltic3 average was 12%, the V5 average was 40%, with the Balkan3 average being 27%. Behind the averages – **compared to 1995** – Hungary was still at a significantly lower level, while Poland had an only slightly lower figure.

Till 2007, the general government debt situation remained acceptable in the region, only Hungary had an above 60% debt level**.**

2.3. Explosion during the crisis

Prior to the crisis, the **general government deficit** of the CEE countries relative to GDP was on the average below 3 per cent, with the exception of the Czech Republic, Hungary and Poland (no figure is available for Croatia). **With the crisis, deficits mostly increased** and the CEE10 were subject to excessive deficit procedure. The procedure was terminated against Estonia before its accession to the euro-zone, Bulgaria in 2012 and Hungary in 2013.

The average **general government deficit** of the CEE11 countries relative to GDP **is smaller than the EU average**. **In 2008 nearly all CEE11 countries' debt ratio was below 40%, with the two usual exceptions: Hungary was at 73%, Poland at 47%.**

General government deficit and debt in the CEE11
(In per cent of the GDP)

	General government deficit		General government gross debt					
	2003-2007	2008-2012	2003-2007	2008	2009	2010	2011	2012
Czech Republic	-3.2	-4.4	28.4	28.7	34.2	37.8	40.8	45.8
Hungary	-7.2	-1.9	62.6	73.0	79.8	81.8	81.4	79.2
Poland	-4.2	-3.9	46.5	47.1	50.9	54.8	56.2	55.6
Slovenia	-1.6	-4.0	26.2	22.0	35.0	38.6	46.9	54.1
Slovakia	-2.6	-4.3	35.6	27.9	35.6	41.0	43.3	52.1
V5	**-3.8**	**-3.7**	**39.9**	**39.7**	**47.1**	**50.8**	**53.7**	**57.4**
Bulgaria	1.1	-0.8	29.5	13.7	14.6	16.2	16.3	18.5
Croatia	n.a.	-3.8	35.7	28.8	35.7	42.2	46.7	53.7
Romania	-1.8	-2.9	16.2	13.4	23.6	30.5	34.7	37.8
Balkan3(2)	**-0.4**	**-2.5**	**27.1**	**18.7**	**24.6**	**29.6**	**32.6**	**36.7**
Estonia	2.0	-0.3	4.7	4.5	7.2	6.7	6.2	10.1
Latvia	-0.8	-1.2	12.4	19.8	36.9	44.4	41.9	40.7
Lithuania	-1.0	-3.2	18.7	15.5	29.3	37.9	38.5	40.7
Baltic3	**0.1**	**-1.6**	**11.9**	**13.3**	**24.5**	**29.7**	**28.9**	**30.5**
CEE11(10)	**-2.0**	**-2.8**	**28.8**	**26.8**	**34.8**	**39.3**	**41.2**	**44.4**
Memorandum								
EU	**-2.2**	**-4.0**	**61.6**	**62.2**	**74.6**	**80.2**	**83.1**	**86.9**
EAP6	**-2.3**	**-8.4**	**68.4**	**70.7**	**84.5**	**96.1**	**107.7**	**115.9**
EACORE	**-0.6**	**-2.7**	**54.7**	**56.4**	**62.6**	**66.1**	**67.1**	**70.0**

Note: The figures of the individual country groups (except the EU) are un-weighted averages.
Source: Eurostat

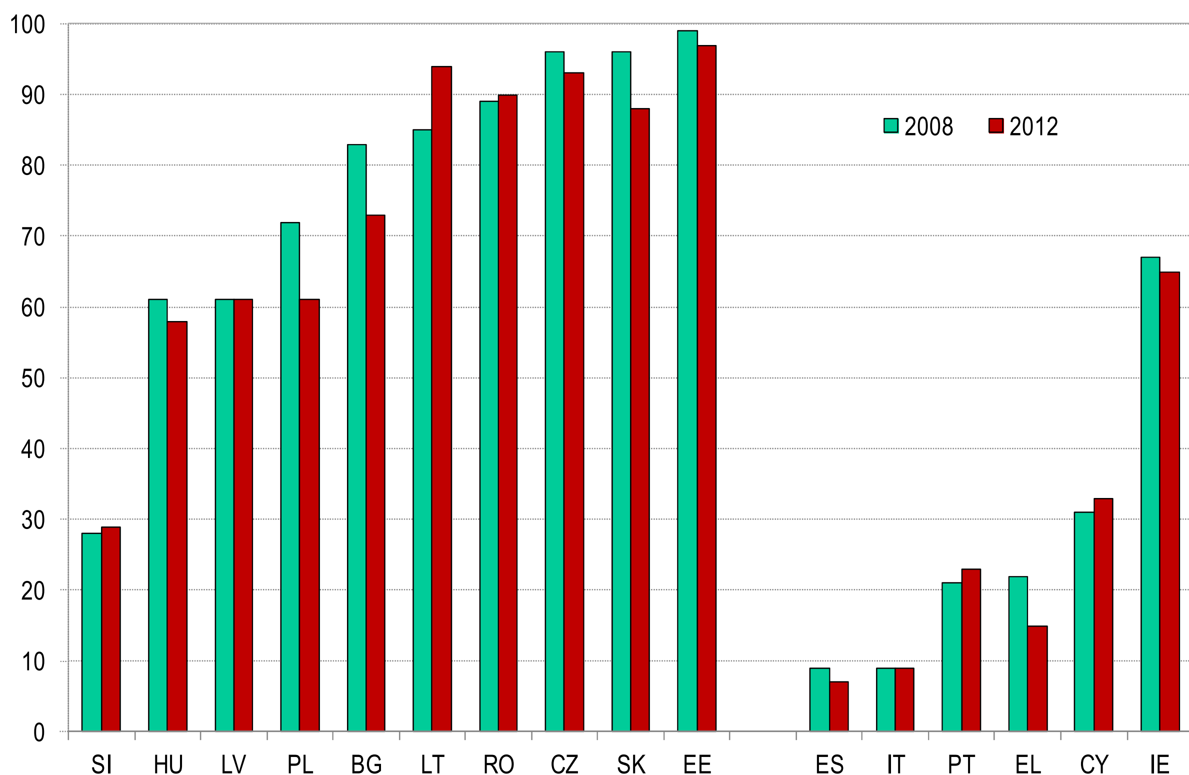
The crisis years created a dramatic increase in public debt. Between 2008 and 2014 (in 6 years) the average debt ratios in these countries increase from 13% to 30% in the case of the Baltic3, from 40% to 62% in the case of the V5, and, from 19% to 40% in the case of the Balkan3, by the forecast of the European Commission. **Each group shows an about 20 percentage points increase, which is dramatically high, but the size is below the EU average, more or less identical** with that of the **EACORE countries.** Their **general government debt is only about half** of that of the EU. Behind the averages there are **significant differences**: more than 30% debt ratio increases in the cases of Slovenia and Croatia, 20-30% increases in the cases of Latvia, Lithuania, Slovakia, the Czech Republic and Romania, but less than 10% increases in the cases of Estonia, Hungary and Bulgaria.

After a huge debt ratio increase, in 2014 the expected Baltic3 average is still only 30%, the Balkan3 average is 40% and the V5 average is 62%, much below the EU countries' average. Only three countries will be **above 60**%: **Hungary** with 79%, **Slovenia** with 66% and **Croatia** with 63%. (There are 9 countries among the EU-28 with higher ratios than the CEE11 highest Hungary. And the EAP6 countries, in a difficult situation, will still have 110-120% debt ratios even in 2014. **The situation in Greece and Cyprus is specific and probably requires extraordinary solutions**, while the crises in the other countries may be treated in the already developed way.) **It is also important, that in the case of Slovenia and Croatia the tendency of the debt ratio remains growing even in 2014**, while in the case of Hungary a nearly stagnating ratio is expected.

The **causes** of the dramatic increase of the debt ratio in the CEE11 are mainly similar to those of the EU as a whole, but there are **differences**, concerning first of all the size of the main explaining components.

As the banking sector in the examined countries is mainly foreign owned (typically by banks based in the EA countries, which mostly participated in the so called Vienna Initiative), and the banking sector in the region was less affected by toxic assets, **the bank consolidation budget expenditures played only a modest role in public debt creation.**

Percentage of the banking system that is foreign owned, CEE10 and EAP6



Note: This percentage is calculated as the total assets of foreign owned subsidiaries/branches as % of total banking system assets
Source: André Sapir, Guntram B. Wolff (Bruegel) 2013.

At the same time, the initial **GDP decline in the CEE11 countries was more severe, than in other parts of Europe.** (The Baltic3 GDP dropped in 2008-2009 by 17% on the average, the Balkan3 GDP in 2009 dropped by 6.6% on the average, the V4 country average – here except Poland – dropped in 2009 by 6%, while the EU declined in 2009 only by 4.5%. The GDP of the EAP6 countries between 2009 and 2012 fell by 7.5% on the average, and the fall has not yet ended.) The GDP decline, **on the one hand, increased the existing debt ratio and, on the other hand, through the automatic mechanisms** (falling revenues versus increasing unemployment benefits and social transfers) **deteriorated the budget balance and again the debt ratio.** Some countries tried to soften the falling business cycle with budgetary measures (tax reductions, spending programs) as well. The substantially higher debt created a **higher interest payment burden**, both leading also to a higher debt ratio.

Between 2007 and 2009 the countries' average ESA deficit increased by 4.5% of the GDP for the V5 and the Balkan3, but for the Baltic3 the deterioration was 7.5%. In the most critical year, 2009, Estonia was still able to keep its budget deficit below 3%, while Latvia and Lithuania reached above 9% levels. The V5 increased the deficit to 6-8%, with the exception of Hungary, who could not afford it (because of the high debt level and the financing problems), the deficit for the country reached only 4.6%. From among the Balkan3, Romania was at 9%, while Bulgaria and Croatia went just a little above 4%.

The structural deficit's deterioration was milder. According to EU staff calculations during the crisis years the highest average structural deficit for the Baltic3 was 5%, for the V5 5.5%, and for the Balkan3 6.5%. **In 2009 the traditionally worst performer Hungary was able to diminish the structural deficit from 4.6% to 2.3%.** The average structural deficit is **below 3%** since 2010 for the Baltic3, since 2012 for the V5 and from 2011 for the Balkan3. Individual calculations show that, **in 2014** only Slovenia will be above 3%.

Following the shock of the crisis year, from 2009, **all countries had to implement fiscal consolidation measures** by cutting general government expenditures and raising revenues in order to reduce the deficit. In fact, with the exception of Bulgaria and the then non-EU member Croatia, **all the CEE countries were subject to excessive deficit procedure that determined to a large extent their fiscal policies.**

As regards expenditures, **typically public administration was downscaled; wages in the public sector, benefit entitlements such as pensions as well as public investments were reduced**. The governments tried to save the social benefits to compensate the effects of the crisis (the only exception is Hungary), On the revenue side, measures were taken to increase the tax base and various tax rates such as VAT rates, while in many countries even **new taxes were created and the contribution payments to mandatory pension funds** were **partially or fully rechanneled into the budget**. In the end, however, in the majority of the countries **budget revenues** as a percentage of GDP, compared to 2007, **remained unchanged or diminished**! (There was a minor augmentation in Estonia and Slovenia.)

Volume change of selected general government expenditures, 2011/2007
(National currency nominal expenditures index deflated by HICP)

	Social benefits*	Compensation of employees
Czech	104	94
Hungary	91	81
Poland	112	113
Slovenia	116	115
Slovakia	119	109
V5	**108**	**103**
Bulgaria	127	106
Romania	136	85
Balkan2	**132**	**96**
Estonia	110	100
Latvia	118	70
Lithuania	123	92
Baltic3	**117**	**87**
CEE10	**116**	**97**

* other than social transfers in kind
Note: The figures of the individual country groups are un-weighted averages.
Source: EU DG ECFIN 2013 spring forecast

The experience of countries is different. In the Baltic3 general government expenditures **were cut dramatically** (including nominal wage cuts) with the partial exception of social transfers and revenues, which were allowed to grow in 2009. In **Bulgaria** emphasis was laid on the improvement of tax revenue collection and the decrease of expenditures. In **Poland** and the **Czech Republic** no fiscal tightening was undertaken initially. In Poland automatic stabilisers were at work, but their effects were neutralised by the reduction of certain discretionary spending items. Nevertheless, no profound structural reforms were implemented. In the Czech Republic fiscal consolidation was launched in 2010 primarily by raising general government revenues.

Between 2008 and 2012 three countries – Bulgaria, Romania and Lithuania – decreased state redistribution, another three countries – Latvia, Poland and Hungary – restructured state redistribution while keeping its previous extent, and four countries – Estonia, the Czech Republic, Slovakia and Slovenia – pronouncedly increased the state's role in the course of trying to put in order their budget. **There are successful and unsuccessful countries in each group.**

2.4. Budget consolidation in the shadow of EDP threat

All CEE11 countries are influenced by actual or potential EDP, as even the non euro-zone countries (all of which are receiving EU Cohesion funds) can be threatened by the eventual freezing of EU financing in case they do not comply with EDP recommendations.(As it happened in 2012 with Hungary).

Presently, from among CEE11 countries, Bulgaria, Hungary, Romania and the Baltic3 are not under EDP, while the deadline for the end of EDP is **2013** for the **Czech Republic** and **Slovakia**, **2014** for **Poland** and **2015** for **Slovenia**. (Croatia as a new member **will face an EDP soon** as well.)

According to the EU spring forecast, the above mentioned 2013 deadlines seems to be realistic, while the latter deadlines are questionable.

Nevertheless, the problem of public finances cannot be simplified to mean the deficit, as the extent of redistribution and the structure of revenues and expenditures also exerts a great effect on growth. **Smart economic policy is necessary, which keeps the general government deficit low with a favourable structure in the budget**.

This requires the national **reconsideration** of the role of the state and the extent and mode of state redistribution. Countries may be successful with very different ratios of state redistribution; however this depends greatly on the characteristics of the operation of the state typical of the given country. According to experiences, **state redistribution is often of low efficiency** in Mediterranean and Central European countries – is not sufficiently targeted and efficient, is influenced by lobby interests and corruption. Thus, the **reduction of redistribution and the simultaneous improvement of its efficiency may be a realistic and socially acceptable goal** (e.g. by reducing the tax burdens related to employment and with it helping the development of the SME sector, together with savings on expenditures by fighting corruption and by the improvement of the targeted character of spending). However, there is no uniform model as far as structural reforms are concerned.

In the great social distribution systems – from health care, through the pension system, to education – it is indispensable to introduce substantial **reforms**, also increasing the **role of self-care** and **of private contributions**. Promoting **self-care** may incite or compel households to **make savings**. Nevertheless, it cannot be hoped that state funds missing from education, health care and social welfare could be substituted completely by private funds in these countries, as they are **lacking** a **broad and wealthy middle class (actually: a strong competitive sphere)**. Therefore, an **excessive withdrawal** of the state from areas requiring human capital **shall be avoided,** as this would be accompanied by **deteriorating competitiveness** and **creating unnecessary social tensions**.

Innovation led development presupposes a **stable regulatory environment**, a **professionally and morally high level and not oversized public administration**, as well as a much higher level of **social trust** in general. This represents a great **challenge** for all countries, to a smaller or larger extent.

The intensification of the **social consequences** of the crisis – from the polarisation of incomes to social marginalisation – may easily create a social and economic situation, in which the **possibilities of further budgetary consolidation narrow down**. The **ability** of the individual societies to **resist and manage crises is also different**. The reduction of the budget deficit depends not only on economic but also on **social sustainability**. While consolidation is unavoidable in all countries in order to keep the trust of the international money markets, this shall be combined with growth, as **without growth the stabilisation of the budget is unsustainable neither economically, nor socially**.

Social welfare systems shall support the needy, and shall not serve lobby interests. The restructuring of social welfare systems **does not mean simply the reduction of transfers** – though in some cases it may also mean that –, but a **restructuring** on the basis of which it is possible to **solve tasks in a more economical, efficient and targeted way**, **building on self-care as well.** It is a peculiar type of **paradox** that under the conditions of crisis the demand for social welfare and job security support intensifies, while growth would require the modernisation related investment of available funds that have become scarcer exactly in this context. (From another aspect, this double character is reflected at the level of the EU as well, in the reduction of the solidarity type **cohesion funds** between 2014 and 2020, which would be so important for CEE countries.)

2.5. Financing the debt

The crisis years convincingly illustrated, that not only the debt level, but also the composition of debt financing matters. Traditionally some countries relied (for different reasons) mainly on foreign financing of the government debt. In the framework of the international financial crisis the **foreign financing quickly dried out** and financing required **international support from EU and/or IMF.**

The real importance of the foreign financing of the state debt (that is the financial vulnerability or dependence of the state on foreign savings) **is better reflected by analysing the ratio of the foreign financed debt to the GDP.** (That comparison differs from the usually published indicators.)

Foreign financed general government gross debt to GDP
(2008, 2012 in per cent)

	government debt / GDP		foreign financed debt / government debt		foreign financed debt / GDP	
	2008	2012	2008	2012	2008	2012
Czech	28.7	45.8	26.2	26.7	7.5	12.2
Hungary	73.0	79.2	51.6	61.9	37.7	49.0
Slovakia	47.1	52.1	34.1	47.4	10.9	24.7
Poland	27.9	55.6	39.1	51.6	16.1	28.7
V4	**44.2**	**58.2**	**37.8**	**46.9**	**18.1**	**28.7**
Bulgaria	13.7	18.5	53.0	47.2	7.3	8.7
Romania	13.4	37.8	31.5	29.4	4.2	11.1
Balkan2	**13.6**	**28.2**	**42.3**	**38.3**	**5.8**	**9.9**
Estonia	4.5	10.1	36.7	64.0	1.7	6.5
Latvia	19.8	40.7	43.3	81.0	8.6	33.0
Lithuania	15.5	40.7	64.2	75.3	10.0	30.6
Baltic3	**13.3**	**30.5**	**48.1**	**73.4**	**6.8**	**23.4**
CEE9	**27.1**	**42.3**	**42.2**	**53.8**	**11.6**	**22.7**

Note: The figures of the individual country groups are un-weighted averages
Source: Eurostat, GKI calculations

In government debt financing, **before the crises, Hungary was by far the most dependent on the foreign savings, while Poland and Slovakia to a much smaller extent, but also relied on that.** The crisis generated a general and in many cases rather substantial increase in foreign financing, as **the rapidly growing debt financing needs coming from the soaring budget deficits could not find sufficient domestic financing** (in an environment of falling household revenues and employment). The outcome was that **vulnerability coming from foreign financing further increased for Hungary statistically (but as market financing was partially replaced by financing by international organizations, not really**), **and Latvia, Lithuania, Poland and Slovakia also reached relatively high foreign debt financing ratios** (and foreign dependency thereby). **Romania rapidly increased the foreign financing to above 10% of the GDP**, and is also treated as a vulnerable country, but as long as it is **backed by the IMF**, this is not a problem. (The size of the yearly foreign financing need also matters.)

Because of the financing problems, Hungary, Latvia and Romania signed EU-IMF programs, while Poland agreed a Flexible Credit Line IMF arrangement.

The above described processes created **vulnerability for countries even with relatively lower general government gross debt ratios.** From the mentioned four countries three always had less than 60% government gross debt ratio. **Latvia's** highest debt ratio was 45%, and the equilibrium position is so strong, that the country **is now introducing the euro. Romania** also produced low debt ratio data, always below 40%, **Poland** was able to keep the below 60% stance.

The CEE11 countries had **significant current account deficits** before 2009, but they were able to produce **remarkable improvement in equilibrium during the crisis** (mainly due to lower imports, but also due to a relatively better export performance). The **Baltic2** and the **Balkan3** improved their position by **extraordinary 10-15 percentage points of GDP**, while the **V5 improved by 5 percentage points**. The EAP6 also decreased the current account deficit but much less rapidly. **Hungary** showed permanent current account **surpluses** between 2009 and 2013, and now Slovenia and Slovakia also have positive current account balances after having significantly diminished the current account deficit.

Current account balance

(As a percentage of GDP)

	2008	2009	2010	2011	2012
Baltic3	-11.5	5.0	1.9	-1.8	-1.8
V5	-5.6	-1.9	-2.2	-2.0	0.1
Balkan3	-14.3	-5.9	-2.1	-1.8	-1.7
CEE11	**-9.6**	**-1.1**	**-1.1**	**-1.9**	**-0.9**
EAP6	**-10.2**	**-7.0**	**-6.2**	**-4.3**	**-1.3**
EACORE	**3.3**	**2.9**	**3.6**	**2.9**	**3.0**

Note: The figures of the individual country groups are un-weighted averages
Source: Eurostat

The capital plus current account improved **even more significantly** (8 countries from CEE11 had surpluses in 2012).

The gross external debt of the CEE11 countries is now below 100% of the GDP. As FDI was historically very significant in the region (contributing markedly to better growth performance), and the great bulk of the private indebtedness is not a country's, but a foreign owned company's (bank's) risk (mostly intra-company), **it is not the general size of external debt, but some components of the indebtedness seem to be problematic. The main problem is the** above discussed **foreign financing of the national government debts.** In the case of the mostly indebted CEE country, **Hungary,** the EU-IMF support was needed **very clearly in 2008 mainly because of the lack of government debt financing** and not because a classical general external financing crisis situation.

A further problem is the **stance of the banking system**, the deleveraging process and its negative impact on growth. In some countries the stock of foreign currency denominated loans (especially in CHF) creates an additional burden for many households and companies as well. (After the crisis the national currencies tended to depreciate, and the CHF appreciated substantially against EUR.) We deal with this topic in the next chapter.

2.6. Short and medium term sustainability

According to the classical theoretical approach and definition, sustainability of debt means: no increase in the general government gross debt to GDP ratio in the following years. From the point of view of budgetary policy formulation the growing government gross debt has two main

consequences. The first is that **the debt shall find continuous financing, preferably by the market.** The second is that **interest payments deriving from the actual debt shall fit into the yearly budget deficit.**

The assumptions behind the no increase debt ratio are that:

- On the one hand, the existing debt level was financed by the market and the continuation of the financing (only with nominal GDP growth increment) can be usually expected.
- On the other hand, with no increase of the debt the interest expenditures remain unchanged compared to the GDP, which can be easily further financed in the framework of the next year's budget, with an unchanged primary balance. (A tightening change is treated by politicians and by the market as creating problems and implementation risks.)

Nevertheless – especially having seen the experiences of the crisis years – such an approach **seems oversimplified.**

- **The market financing of a given debt level cannot always be treated as automatic, especially if the financing is based on foreign savings.**
- There are examples where even an increasing debt ratio was treated by the market as sustainable. A very high debt ratio might remain sustainable if **domestic savings** can finance it (the extreme example is **Japan**).
- The interest expenditures of the budget are influenced not only by the debt level, but also by the level of the **market yields** of the government bonds financing the debt (reflecting the internationally existing base rates, the rapidly changing risk premiums and the exchange rate fluctuations as well).
- There are a lot of **other factors** influencing the need for changes in the primary balance.
- The existing (low or high) **treasury reserves** might potentially influence the gross debt, and can diminish the net interest rate expenditures of the budget as well.
- There are **hidden gross debt ratio modification potentials** in the form of the state financial (and non financial, but saleable) assets, and in the form of the foreign currency denominated debt, via the **exchange rate fluctuations**.
- **Even a less than 3% budget deficit** – which is treated as the benchmark of responsible budget policy – **may generate an increase in the debt ratio** (with low inflation, poor growth performance and low base debt ratio data), which is not certainly unsustainable.
- The '**stupidity of the existing accounting rules'** unfortunately allowed the budget equilibrium and the debt ratio to improve by **rechanneling the mandatory private pension funds contributions and even the capital into the general government budget.** (It is not a real budgetary tightening, as the contribution to the pension funds was saved, and as long term indebtedness – implicit burden of the budget – increases with the change.)

Pragmatic experience during the preparation of the yearly or medium term budget shows that the **importance of the interest expenditures/GDP ratio fluctuations is limited** (even an increase of the ratio is possible). There are many other items on the revenue and expenditure side, where the automatic change of the expenditure or revenue ratio is determined by different factors (growth shocks, new legislation, demographic changes, international flow of tax-paying working force, court rulings, ongoing large investments), which makes necessary to implement policy changes anyway, and a small increase in interest expenditures does not make a great difference. (In the case of the most indebted Hungary the interest rate expenditures ratio to GDP between 2003-2007 averaged 4.2%, while later the maximum was 4.7% in 2009 and the 2009-2012 average is 4.3%).

The essence, the main message of the original rule is that according to a medium and longer term forecast, **the debt ratio shall not skyrocket, it shall be limited,** and even if it can be financed**, it shall not require unrealistic budgetary tightening** and **too high primary balance surplus. The availability of market financing is always a tougher issue. To judge the sustainability of the debt, there is a need for deeper analyses,** based on different considerations.

It is probably useful, to a first approximation, to treat the government gross debt of an EU country sustainable in a medium term if the country is not under EDP because of the new rules for the debt developments. According to these: the ratio of general government debt to GDP shall be under 60%, or **if it is above 60%,** the debt ratio – in a 3 years average – **shall diminish yearly by 1/20** of the difference between the base year's debt level and 60%. (**Purely mathematically**, of course, **the rule is faulty**, as keeping this rule using always a different base year **the debt will never go below 60%,** but this will cause no problems in practice.)

The **second approach shall be the analysis of debt financing.** In the case of significant foreign financing (for example whenever the debt is above 50% of the GDP and the foreign share is above 20%, or whenever the foreign financed debt amounts to more than 10% of the GDP) the debt should only be treated sustainable if the credit ratings and the risk premium analyses **do not signal any danger** in continuous market financing. **A further analysis is needed in case a rapid and significant growth of the costs of financing is expected**. In this case, the general stance of the budget, and the necessary policy actions should be revaluated.

According to the first approach, Slovenia, Croatia and Hungary are presently not meeting the new EDP debt criteria. (The rule is **not applied yet** during EDP, as we are now in a transitional period, but it will soon be implemented.)

In the case of Hungary, the main problem is the very poor growth performance. The deficit may be kept below 3%, but instead of the needed roughly 1% improvement at the debt ratio, only a smaller decrease is expected. (The forint exchange rate and the size of the treasury reserve can influence the final outcome.) **The tools used by Hungarian government for achieving a less than 3% budget deficit** (the extreme high role of the targeted sector surtaxes, especially affecting the financial sector, together with the uncertain economic and legal environment) **explain** the lack of growth. **The tax system shall be rescheduled and new policies are needed to restore business confidence in order to support growth. There is no sense in decreasing inflation with artificial measures (which is the present practice).**

In the case of **Croatia and Slovenia, the debt is above 60% and** is still expected **to grow considerably in 2014**.

In Slovenia the budget **deficit** jumped to 6.2% in 2009 and similar deficits occurred in 2010-2011. In 2012 some improvement took place, as 4% was reached, but in 2013-14 again about 5% is expected. Inflation (the GDP deflator) created only minimal yearly growth on the average between 2008 and 2014 and the **real GDP heavily declined**. The nominal GDP declined in 2009, and is stagnating since then. Under such circumstances the **debt ratio has been increasing rapidly** (from 22% in 2008 to 66.5% in 2014). **Growth support and fiscal consolidation are needed, and even higher inflation may help to stabilise the situation.**

In Croatia the debt increased from 28.8% (in 2008) to 62.5% (in 2014). The budget deficit in 2011 was at 5.7%, later in 2012 some improvement occurred to 3.8%, but further deterioration (yearly about 1%

point) is expected for 2013-14. The GDP decline and the very low inflation created nominally declining GDP in 2009 and later mostly stagnating nominal GDP, which with the high budget deficits led to an increase in debt. **Fiscal consolidation and growth support are needed again, and even higher inflation may help to stabilise the situation.**

In the case of **Slovenia, even the financial market sentiment deteriorated**, and there are speculations that an **EU-IMF program** would be applied. After the expected monetary tightening by the FED (and later by ECB), the financing of all above mentioned problem countries **might face difficulties**.

2.7. Long term sustainability

Sustainability shall be analysed in a long run as well. First of all, the **ageing population** (the pension system obligations, the implicit government debt, and the expected additional health care spending necessities) problems are significant, but there are other important **demographical**, **environmental** issues as well. Especially since due to the rapid growth of the debt ratio the interest rate burden on debt has also become a very important element.

The European Commission elaborates a so called "Fiscal sustainability report" from **time to time**, the latest was published in 2012 (European Economy 8/2012). Further on we shall refer to some features of the study related to the examined CEE10 countries (Croatia was not analyzed), **using only the forecasted basic scenario for 2030.**

> Naturally the calculations in the report incorporated **the autumn 2012 EU economic forecasts for 2014,** in which the data were slightly different from the above used spring 2013 EU forecast. Wherever the difference is significant, it may have an impact on the long term budgetary calculations as, according to one of the basic assumptions, the 2014 primary structural balance related to GDP is kept unchanged later on till 2030. Nevertheless we use the calculations of the original study, but the major deviations during assessment will be mentioned. The difference is above 0.5% only for four countries: Slovenia is worse by 0.6%, while Hungary is better by 0.6%, Lithuania is better by 0.9% and Poland is better by 1.4%.

The main forecast results for 2030 can be described as follows:

a) **The Baltic3 show a positive outlook in the long term sustainability of selected and forecasted parameters**. The initial debt level is low, the primary balance is strong, and the additional costs related to the ageing population seem to be manageable. The assumed conditions create a negative snowball effect.

The 2030 basic budgetary scenario forecast for the Baltic3

	Primary deficit	Ageing costs	Other one-offs	Snowball	Debt change	Debt level
Estonia	-0.4	0.6	-0.6	0.1	0.3	14.3
Latvia	-0.4	1.6	-0.3	0.3	-1.4	31.7
Lithuania	0.1	1.5	0.1	0.8	2.5	63.9
Baltic3	**-0.2**	**1.2**	**-0.3**	**0.4**	**0.5**	**36.6**

Source: EC Fiscal Sustainability Report 2012

The only slightly problematic country is Lithuania, but assuming the latest forecasted primary structural surplus for 2014, the 2030 debt ratio will be much below 60% (and the yearly debt increase in 2030 is only 1.6%)

b) **The V5 show a somewhat surprising outlook. Hungary is forecasted to go below the 60% debt ratio in 2030**, due to the significant structural primary surplus reached during the crises years and due to the diminishing ageing expenditures (thanks to the ongoing retirement age increase and the drastic diminishing of early retirement). **Poland is also very likely to remain below 60%,** as the 2014 primary structural surplus is much better than originally calculated. The additional costs related to the ageing population are modest for the largest country in the region, but the snowball effect creates a burden. The **Czech Republic and Slovakia show** very high yearly debt increases and an approximately **80-90% debt level in 2030**, while the worst results came out for **Slovenia** with an **above 100% debt ratio** (which can be even higher taking into account the now predicted 2014 primary deficit). The negative developments come from the initial sizable debt and the primary structural deficit, which are further worsened by the high costs related to the ageing population and the snowball effect. **For the three last mentioned countries (Czech Republic, Slovakia and Slovenia) substantial adjustments are unavoidable.**

The 2030 basic budgetary scenario forecast for the V5 countries

	Primary deficit	Ageing costs	Other one-offs	Snowball	Debt change	Debt level
Czech	0.9	1.4	0.1	0.8	3.2	78.7
Hungary	-1.6	-2.2	0.3	0.6	-3.0	53.1
Poland	-1.0	1.0	0.3	0.9	1.2	62.0
Slovakia	0.8	2.3	0.2	1.0	4.3	91.6
Slovenia	-0.1	2.7	0.1	1.5	4.2	105.5
V5	**-0.2**	**1.0**	**0.2**	**1.0**	**2,0**	**78.2**

Source: EC Fiscal Sustainability Report 2012

c) The now examined **Balkan2 countries show a stable outlook, similarly to the Baltic countries.** The initial primary surplus and the low indebtedness, the modest additional costs related to the ageing population, and the modest snowball effect allows them to reach a below 40% debt level in 2030.

The 2030 basic budgetary scenario forecast for the Balkan2 countries

	Primary deficit	Ageing costs	Other one-offs	Snowball	Debt change	Debt level
Bulgaria	-0.3	1.3	0.3	0.5	1.9	37.6
Romania	-0.7	1.3	0.1	0.6	1.3	37.5
Balkan2	**-0.5**	**1.3**	**0.2**	**0.6**	**1.6**	**37.6**

Source: EC Fiscal Sustainability Report 2012

In the case of **Croatia** the age related expenditures might slightly diminish by 2030 according to national forecasts, but the initial primary structural deficit and the high initial debt ratio, together with a sizable snowball effect, may also create **a well above 60% debt ratio forecast.**

Of course the calculations show the base scenario according to a **no primary balance change assumption**, but **different measures may dramatically influence the outcome on the long run. The main lessons can be summarised as follows**:

- The **creation and the long term preservation of a visible size primary structural balance surplus are unavoidable. Further,** the growth generated additional budget revenues shall not be fully spent in higher debt countries.

- To diminish the budgetary burden derived from the ageing population **further pension reforms are needed.** Mandatory private pension systems shall be preserved and the original contribution rates restored in order to diminish for a longer period the future budgetary pension expenditures. Retirement ages shall follow the changing life expectancies.

- The assumptions in the report regarding the long term macro framework consist of a 1.5-2% real growth, 2% inflation (GDP deflator) and around 5% implicit interest rates, which lead to the increase of the debt through the so-called snowball effect. The policies should aim at achieving a better macro framework. **Higher growth, cheaper debt financing can help and even a somewhat higher inflation can be considered.** (For the EU and for the euro-zone not inflation but high government debt is nowadays the much more severe economic equilibrium problem.) Even the used assumptions shall be revised, as a 3% real interest seems to be overestimated in the long run, especially if the low growth environment remains. There are arguments (for example from Rogoff) suggesting that yearly inflation in the long run could go up to 3%. But keeping the 2% forecast, the reasonable implicit interest rate can be lower than 5%.(Now the implicit average government debt nominal interest rate for the Czech Republic is 3.4%, for Slovakia is 3.7%,for Latvia 3.8%)

New calculations shall try to take into account other long term budgetary processes as well, like demographic changes (not only in pensions but in child benefits and education costs as well), expected large government investments (for example in the energy sector), social expenditures reflecting the social changes, the likely impact of technical development on the costs of state administration. (Present calculations cover only less than the half of the usual budget spending.) It may also make sense to harmonise the new EDP debt rules with the methodology, as the rule requires each member country with an above 60% debt ratio to reach the 60% in 20 years (not by 2030, as other calculations in the report assumed).

3. Banking sector

Banking is one of the most strongly hit industry by the crisis. In the first wave of the panic **the quick substantial state aid was unavoidable**. But it is **shocking** that (according to Bruegel 2013. September publication): the number of cases of state aid bank support (more than guarantees) was **13 in US** and 50 in euro-area and **88 in EU** as a whole. This tool had been used only in the first two years of the crisis by US and **permanently in EU**. This difference is clearly connected with the debate of bail-in or bail-out.

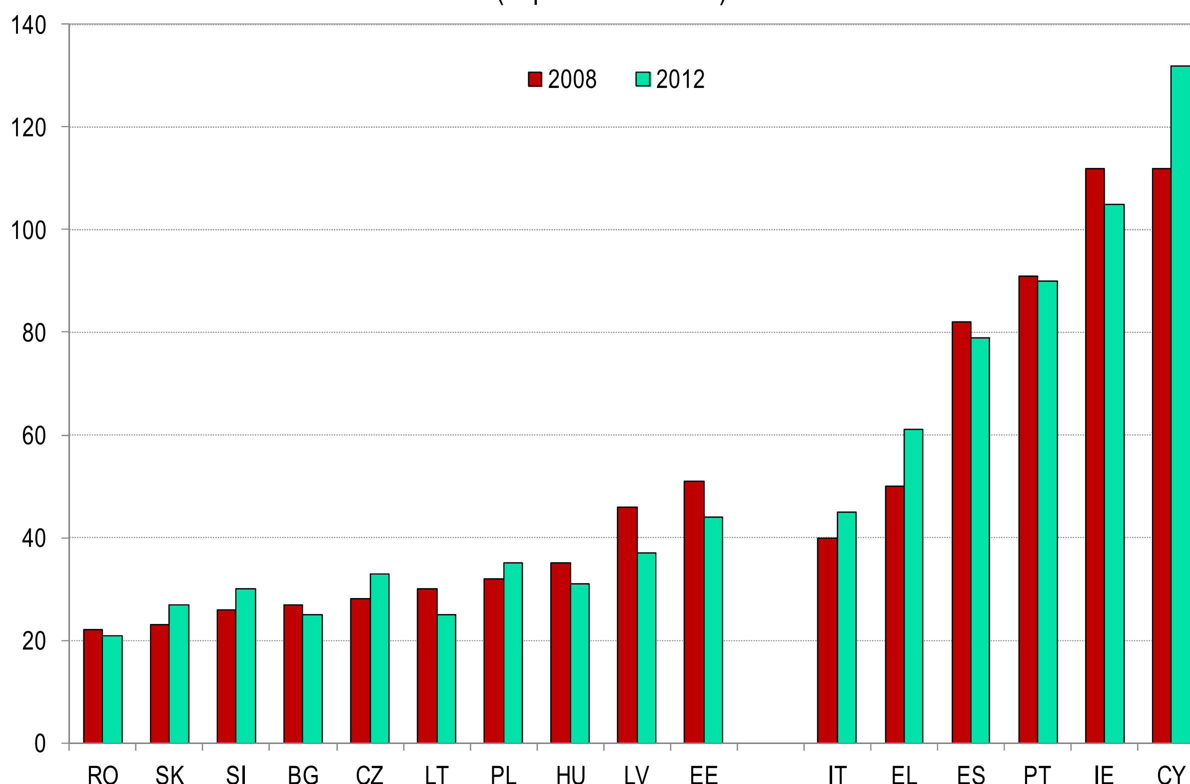
The financial crisis highlighted **the effect of excessively high private debt stocks and rapid credit expansion on financial stability and economic growth**. Prior to the crisis the low levels of interest rates, relatively stable inflation paths, decreasing risk premiums, higher future-income expectations and the development of the Single Market in financial services created **credit bubbles in many EU countries**. Credit expansion in both **household** and **corporate** sectors was an **important driver of growth** during the pre-crisis period. New member states differed in the significantly higher cost of consumer credit, associated with higher risk premiums. Moreover, **even within the euro-zone there were differences in interest rates, only smaller than the present ones**: while SMEs in the Netherlands or Finland could obtain credit at 5%, in Portugal they could only do so at 6.5-7% (whereas German interest rates were between the two!).

The crisis revealed the **unsustainability of the level of the private sector debt** with respect to income prospects and assets in several member states. Despite the fact that new member states had significantly lower levels both in absolute and relative terms, private sector adjustment was necessary particularly in view of the **high level of external funding in the banking sector in CEE11 countries**. **Private** (means household, financial and corporate) **sector debt was the highest in Hungary, Bulgaria and Estonia;** in these countries it reached 150% of GDP, the average level of EU. **Deleveraging pressures were strong where the country's**

- net external financial assets/GDP were high (up 50%); and
- net assets of households had insufficient coverage to net corporate assets.

That was the case basically **in Hungary and partially** (concerning external assets) **in Bulgaria, Latvia and Romania,** and that was the main problem for EAP6 countries as well.

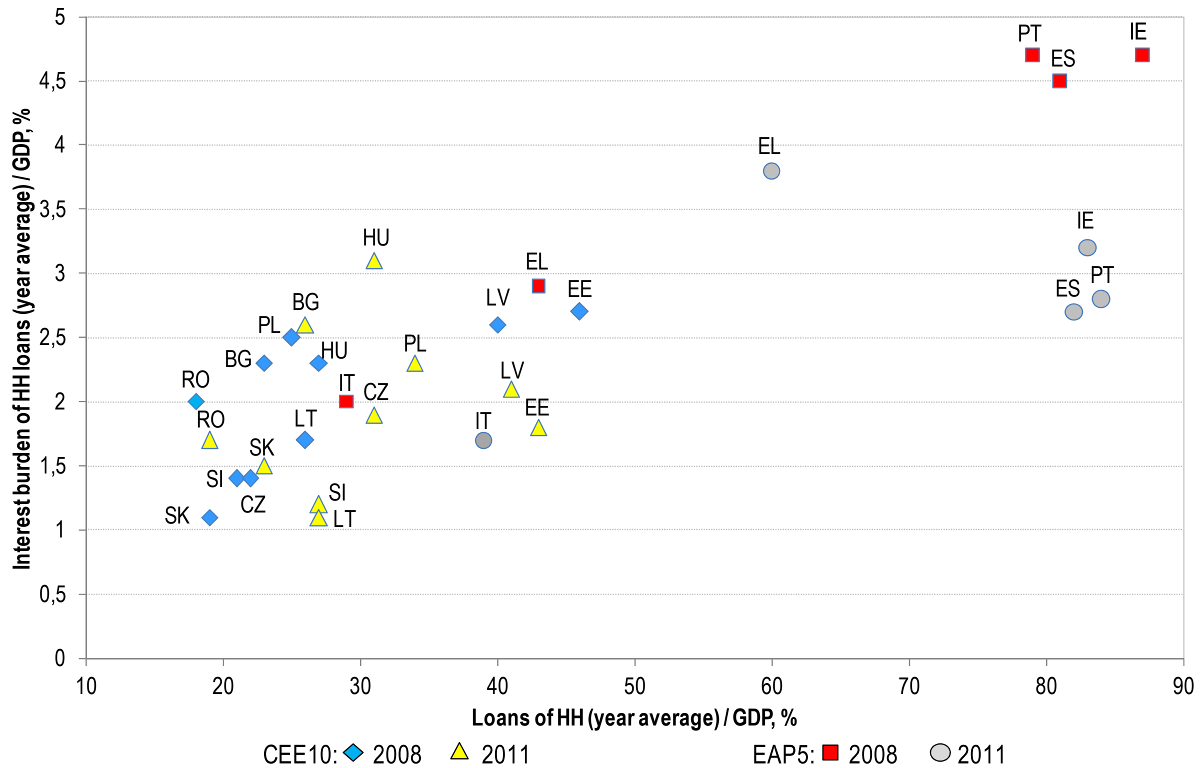
In the crisis, due to increased economic uncertainty, **long-term loans decreased more,** than short-term ones in most countries. As long-term loans are more dominant in the household sector, decreasing credit demand should be more obvious in this case. According to the analysis of Hungarian central bank, **household deleveraging is primarily demand driven**, while **corporate sector deleveraging is rather supply driven**. Furthermore, it is a regular statement recently that the **conditions of SME financing may differ substantially** (by up to 300-500 basis points) **between countries, depending on sovereign risks**. And this makes the SMEs of countries in difficulty uncompetitive.



Source: Mihály Kovács (2013)

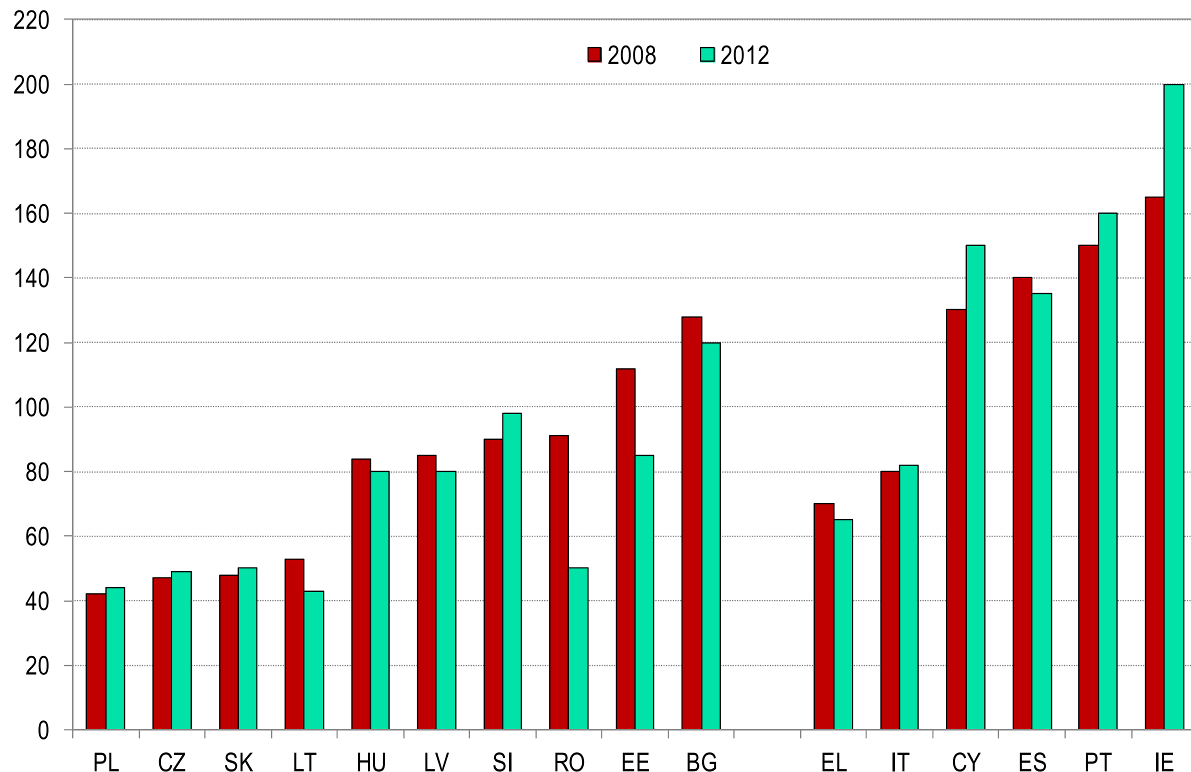
In the 2008-2012 period household sector debt/GDP increased in Slovakia, Slovenia, Czech Republic and Poland, while **substantially falling in Hungary and Baltic3**. (A similar decrease took place in Spain and Ireland, a very modest one in Portugal.)

In spite of the fact that the indebtedness of households to GDP decreased both in Hungary and the Baltic3, the interest payment burden to GDP **changed differently**. In 2011 the interest burden decreased substantially as compared to 2008 in all three Baltic countries, while **increased considerably in Hungary**. Due to money market risks, the relatively large foreign and general government debt, and uncertainties in governance, Hungarian **interest rates got stuck at a high level for a longer period**.



Source: Szigel-Fáykiss (2012)

In some countries, for example in **Hungary, Croatia and Poland, FX (basically CHF) denominated indebtedness created an extra burden on households**. Thus, in Hungary not only the interest burden augmented but, because of the appreciating CHF, the principal and its monthly instalments as well. The share of FX loans is the highest in Hungary, reaching 55% for household as well as for the corporate sector. The weakening of national currencies against the CHF and the euro increased the share of non-performing loans, for example in Hungary, to close to 20%, while the same indicator of the euro-zone is around 8%. (However, it is important to know, that in many cases the NPL share of HUF denominated loans reached the same level, so **the problem is first of all not the FX denomination, but the credit bubble and the worsening situation in the labour market** – decreasing employment and increasing unemployment.) Hungarian banks – on the basis of the decision of the government(!) – spent at minimum 1% of GDP to partially solve the problem, while the budget spent about 0.5% of GDP for this purpose, but **these – because of the bad targeting – all could not stop the permanent increase of the NPL share**. In **Bulgaria** – without a significant indebtedness in FX – the NPL rate in the banking sector reached 17%, while in **Slovenia it showed** 15%, but here in the three largest state-owned banks it rose up to 22%, and rose to 24% in the corporate sector. The situation may deteriorate further.



Source: Mihály Kovács (2013)

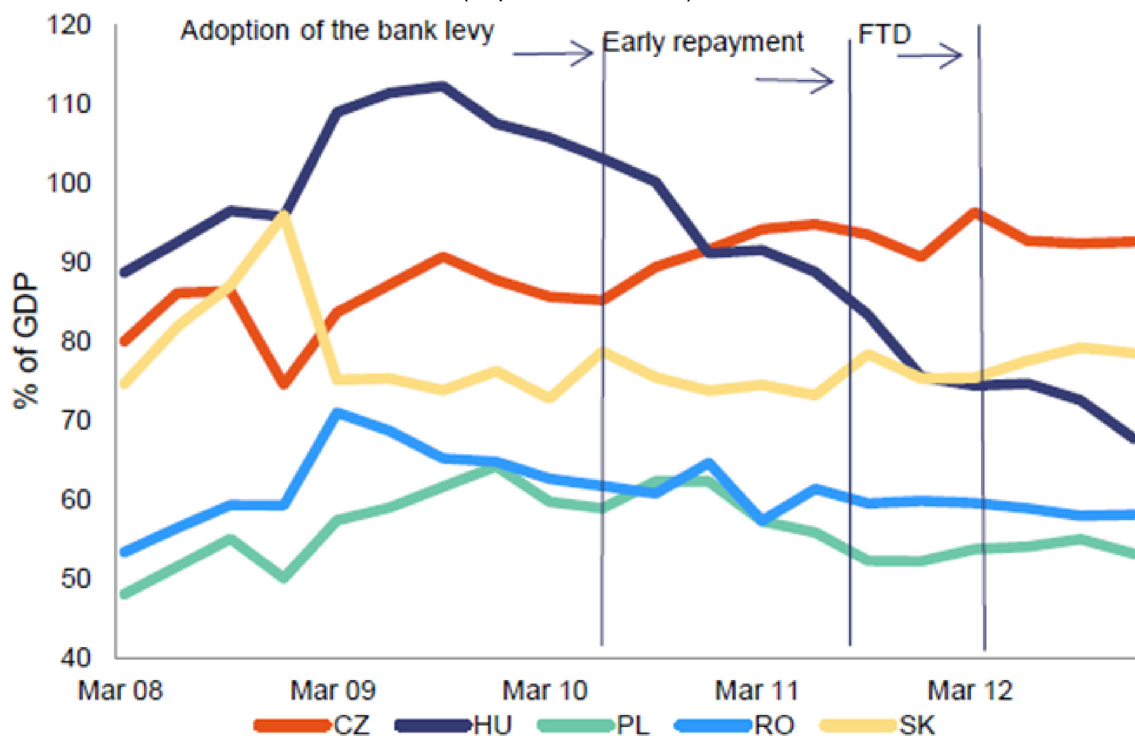
In the **corporate sector** debt/GDP increased in Poland, Slovakia and Czech Republic and until 2011 in Slovenia. Two of the first three countries are among best performers in the region, what evidently shows the **strong connection between credit supply, investments and growth**. In most of EU10 countries (Baltic3, Balkan2 and Hungary) the corporate sector debt **decreased in the past four years**. As concerning corporate lending the supply side pressures are more important in Hungary and Slovenia. It is interesting to note that these are **two completely different situations**. In Slovenia, the majority of banks (large banks), through a complex system of cross holdings, **remained in the property of the state**, while **in Hungary the situation is just the opposite**: there are practically no major commercial banks in state ownership. But the **government pressure** on the banking sector is extremely strong through regulation, surtaxes and negative (victimizing) media image. This also shows that the **banking sector cannot operate normally when risk taking is uncertain**. According to Coface Central Europe, the insolvency rate increased substantially in the region after 2008.

In EAP6 the corporate sector debt slightly fell in Greece and Spain, but we can see a small improvement in Italy and Portugal and a robust increase in Cyprus and Ireland. Gilles Moec, the chief economist of the Deutsche Bank declared to The Economist (16 May, 2013) that it can be proved statistically, that **banks in the periphery discriminate SMEs**: they reject the credit application of the latter much more easily, they charge higher interest rates and fees. If it is important to stop the process of deleveraging, then a **part of the lending risks of commercial banks shall be assumed by the state**: by guarantee funds, by securitisation or by the involvement of credit rating agencies. In a formula:

SME lending (in crisis time) = fiscal policy by proxy + repairing monetary policy transmission

Government policies have substantial consequences on credit flows, investment and GDP growth. As in many countries foreign funding for banks is closely linked to sovereign funding costs, **sovereign risk and banking credit supply behaviour are strongly connected**. In countries with high sovereign risk, for example Slovenia and Hungary, loan supply pressures, have been aggravated by government measures burdening the financial sector and reducing the growth performance of the economy. "Based on composite indicators of loan demand and supply pressures Hungary seems to have experienced the highest supply pressure among European countries in the past year, while demand pressure stands around the EU average. Deleveraging has resulted in high economic costs, with the falls in both credit and GDP being among the largest in Europe compared to pre-crisis levels."[5] **Policy measures** increasing the burden on the financial sector included introduction of a very high bank levy and a financial transaction duty (together 1.4% of GDP) and an early repayment scheme (with a one-off burden close to 1% of GDP). On the other hand, lending conditions had been permanently worsened by banks because of risk aversion. In such a situation there is no incentive for the banks to grow. As the profitability of the Hungarian banking sector disappeared the country had important losses in the allocation of foreign funds for banks. Parent banks optimise return on invested capital.

Banks foreign funding exposure in the CEE5
(In per cent of GDP)



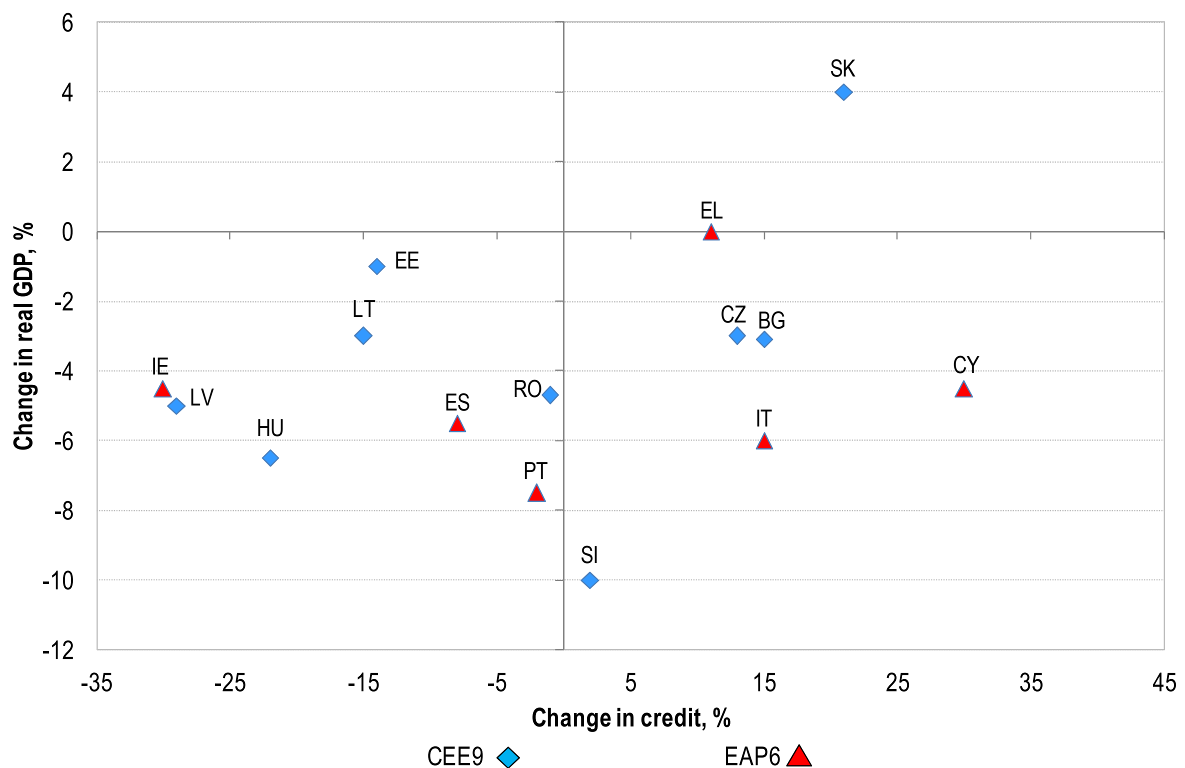
Source: Mihály Kovács (2013)

Obviously financial disintermediation and economic unpredictability (for example a bank levy and a transaction tax with unclear exit horizon) created such a business climate, in which there is very low demand for credit, first of all among SMEs. Unsurprisingly Hungary's track record in credit change and GDP performance is one of the worst in the EU10. **For the CEE11, the most important lesson from all this is that it is not possible to overcome the crisis without the consolidation of the banking sector.** As attractive as the Hungarian example may be in a populist

[5] Mihály Kovács (2013)

type of interpretation, where banks are made responsible for the crisis and are criminalised on this basis, **this path shall definitely not be pursued**.

In general **the medium term perspectives of the CEE banking sector are positive**. The ULC is competitive for investors who don't want to invest only in Asia, the integration into the Western-European supply chain remains an advantage. Reflecting steadily improving loan to deposit ratio in most CEE-countries there is an increasing independence from foreign funds. On the other hand a banking sector with high reliance on parental funds, with high NPL burden and weak economic prospects may suffer from the credit-supply shortage and face of vicious circle in the economy, unless supported by international organizations.



Source: Mihály Kovács (2013)

4. Social welfare and labour market

As a result of the crisis in 2009 almost all EU countries were confronted with **recession**, which eased somewhat later on, but led to further **setbacks** in numerous European countries between 2010 and 2012. The escalation of debt crises in several Member States led to significant policy shifts towards sharp fiscal consolidation by and large across the EU, with adverse further negative effects on aggregate demand. As a result, the previous timid employment growth came to a **standstill** and unemployment reached levels not seen in more than a decade. Simultaneously, **the social situation is deteriorating, especially in member states in Southern and Eastern Europe**, as the effect of national automatic stabilisers, which played an important role in keeping up household expenditure and protecting the most vulnerable in the first phase of the crisis, has weakened more recently.

Very importantly, **social and employment trends are presently diverging significantly in different parts of the EU.** A **new divide** is emerging between **countries that seem trapped in a downward spiral** of falling output, massively rising unemployment and eroding disposable incomes, and those that have shown **some resilience** at least so far – partly thanks to better functioning labour markets and more robust welfare systems, although there is also uncertainty about their capacity to resist continuing economic pressures. The crisis has, additionally, **not impacted uniformly across the whole population** and has often led to an even worse situation for groups already at heightened risk, notably **young adults**, **children** and to some extent **migrants**, thus **contributing to social polarisation**. Recent consumer surveys indicate that the social situation has further deteriorated since 2010 in most member states, with **the poorest quartile being affected more than the average**. There is a need for greater solidarity within the EU today on account of the economic and social crisis. **The crisis is not affecting all of the member states to the same extent** and that in many peripheral states (southern and eastern Europe) there is a "social emergency". In this connection, **unemployment is an absolutely crucial issue**, nor is it confined solely to the alarming observation that the unemployment rate has reached unprecedented levels. It also raises the problem of a **growing polarisation among the members of the euro zone**.[6]

Social policies are trump cards in the sphere of economic competition. Thus **it is necessary to strengthen those social policies that are designed to ensure employees' well-being**. The direct link exists between economic production capacity, competitiveness and employees' health and well-being.[7]

4.1. Social issues

4.1.1. Poverty and social exclusion

The European Union strategy – Europe 2020 strategy – for smart, sustainable and inclusive growth put forward by the European Commission provides a growth strategy for the coming decade. A **European platform against poverty** is one of the seven flagship initiatives of this strategy. Additionally one of the key objectives of the Europe 2020 strategy for the whole European Union is to reduce poverty by aiming **to lift at least 20 million people out of the risk of poverty or social exclusion by 2020**.

[6] Marie Billotte, Sofia Fernandes: (2013)
[7] Marie Billotte, Sofia Fernandes: (2013)

In 2011, there were **119.6 million people** in the EU27, equivalent to **24.2% of the entire population, who lived in households facing poverty or social exclusion**. Although the number of people at risk of poverty or social exclusion declined during the period from 2005 to 2009, this trend was reversed in 2010 and 2011, as the proportion rose by 1.1 percentage points (equivalent to 5.8 million people) when comparing 2011 with 2009. This proportion for the EU27 masks considerable variations between EU member states[8]. In 2011, the proportion of **people at risk of poverty or social exclusion varied between 15.3% in the Czech Republic and 49.1% in Bulgaria**. Amongst the CEE11 countries **Estonia, Slovenia, Slovakia and Poland** were in a **relatively better position** than the average with proportions of 23.1%, 19.3%, 20.6% and 27.2%, while **Hungary, Croatia, Latvia, Lithuania and Romania** in relatively worse positions with 31%, 32.7%, 40.4%, 33.4% and 40.3% respectively.

In 2011, 16.9% of the EU27 population was assessed **to be at risk of poverty**, with this share ranging amongst the CEE11 from 9.8% in the Czech Republic to 22.3% in Bulgaria. Between 2008 and 2011 the proportion decreased in Estonia, Latvia and in Romania.

People at risk of poverty or social exclusion by type of risks 2005, 2008, 2011

	At risk of poverty rate			Severe material deprivation rate			People living in households with very low work intensity*		
	2005	2008	2011	2005	2008	2011	2005	2008	2011
Czech Republic	10.4	9.1	9.8	11.7	6.8	6.2	7.1	5.7	5.1
Hungary	13.6	12.5	13.9	23.0	17.9	23.1	7.6	9.6	9.4
Poland	20.6	16.9	17.7	33.8	17.9	13.0	11.8	6.5	5.5
Slovenia	12.2	12.3	13.6	5.1	6.6	6.0	6.9	5.4	6.0
Slovakia	13.2	10.8	12.9	22.1	11.7	10.5	5.5	4.2	6.1
V5	***14.0***	***12.3***	***13.6***	***19.1***	***12.2***	***11.8***	***7.8***	***6.3***	***6.4***
Bulgaria	-	21.4	22.2	-	41.2	43.6	-	6.2	8.3
Croatia	-	-	21.1	-	--	14.9	-	-	12.7
Romania	-	23.3	22.3	-	32.9	29.4	-	6.6	5.4
Balkan3	***-***	***22.4***	***21.9***	***-***	***37.1***	***29.3***	***-***	***6.4***	***8.8***
Estonia	18.3	19.4	17.4	12.3	4.9	8.6	7.3	4.0	7.7
Latvia	19.3	25.5	19.1	38.9	18.9	31.3	6.3	4.0	9.7
Lithuania	20.6	20.0	20.1	32.6	12.4	18.6	7.7	4.1	9.7
Baltic3	***19.4***	***21.6***	***18.9***	***27.9***	***12.1***	***19.5***	***7.1***	***4.0***	***9.0***
CEE	***16,0***	***17,1***	***17,3***	***22,4***	***17,1***	***18,7***	***7,5***	***5,6***	***7,8***
EU	***16.4***	***16.5***	***16.9***	***10.7***	***8.5***	***8.7***	***8.1***	***7.0***	***7.8***

Note: The figures of the individual country groups (except the EU) are un-weighted averages
Source: Eurostat; *population aged 0 to 59 years

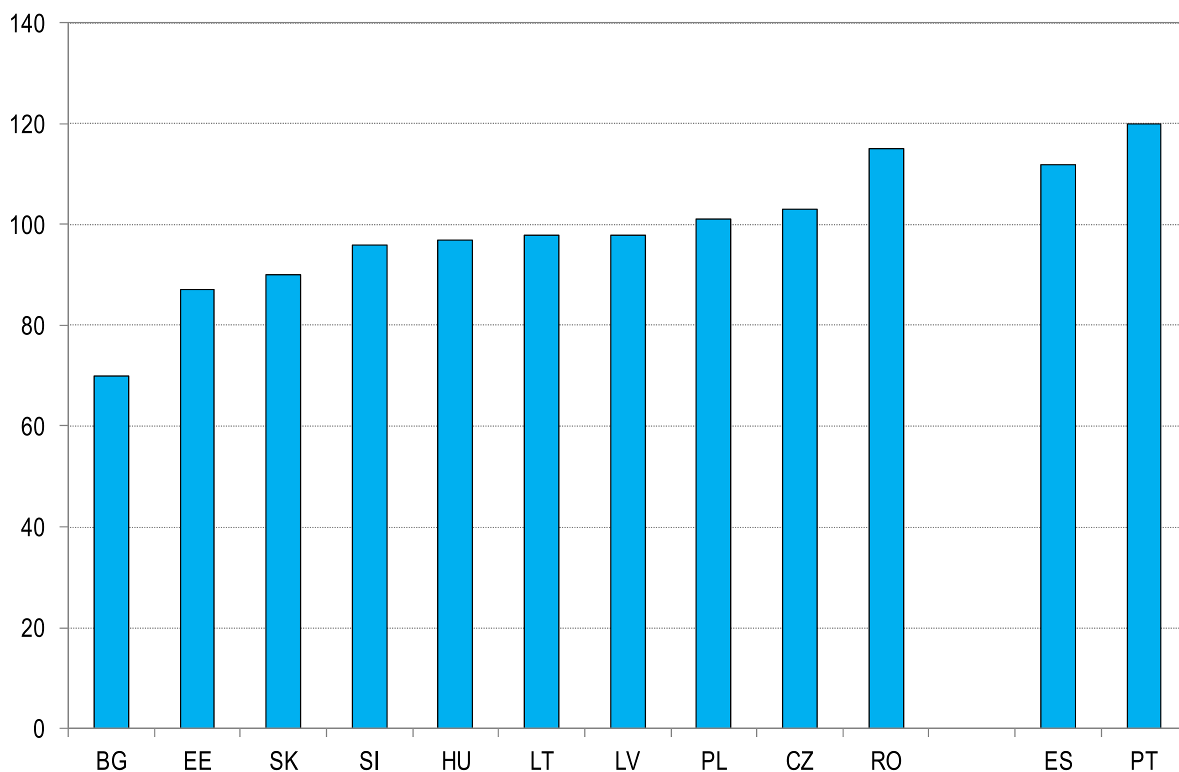
The definition of **severe material deprivation** is based on the inability to afford a selection of items that are considered to be necessary or desirable, namely: having arrears in mortgage or rent payments, utility bills, hire purchase instalments or other loan payments; not being able to afford one week's annual holiday away from home; not being able to afford a meal with meat, chicken, fish (or vegetarian equivalent) every second day; not being able to face unexpected financial expenses; not being able to buy a telephone (including mobile phone); not being able to buy a colour television; not being able to

[8] European social statistics (2013)

buy a washing machine; not being able to buy a car; or not being able to afford heating to keep the house warm. The severe material deprivation rate is defined as the proportion of persons who cannot afford to pay for at least four out of the nine items specified above. Following this definition, 8.7% of the population was severely deprived in the EU27 in 2011[9]. **Among CEE11 countries they were huge differences.** In **Bulgaria** and **Latvia, more than 30%,** in Hungary and Romania between 20 and 30 %, while **in Slovenia, Estonia and Czech Republic less than 9%** of the population fell within this category. Between 2008 and 2011 the proportion could **decrease** only in the **Czech Republic**, **Slovenia**, **Slovakia** and in **Romania, while it deteriorated significantly in the** Baltic3, Hungary and in Bulgaria.

Amongst the CEE11 countries net income of the minimum wage worker as a per cent of at-risk-of-poverty threshold was higher than 100% in Romania, in the Czech Republic and in Poland, while the lowest rate was measured in Bulgaria.

Net income of the minimum wage worker as a per cent of at-risk-of-poverty threshold, 2011



100 means that the equivalised net income of households is equal to the at-risk-of-poverty threshold At-risk-of-poverty threshold = 60% of the national median equivalised disposable income after social transfers
Source: Klara Stovicek (2013)

Work intensity is the ratio between the number of months that household members of working age (persons aged 18-59 years, who are not dependent children) worked during the income reference year and the total number of months that could theoretically have been worked by these household members. **People living in households with very low work intensity** are defined as people of all ages (from 0-59 years) living in households where the members of working age worked 20% or less of their total potential during the previous 12 months[10]. **7,8% of the EU27 population lived in households with very low work intensity in 2011**, with some variation between member states.

[9] European social statistics (2013)
[10] European social statistics (2013)

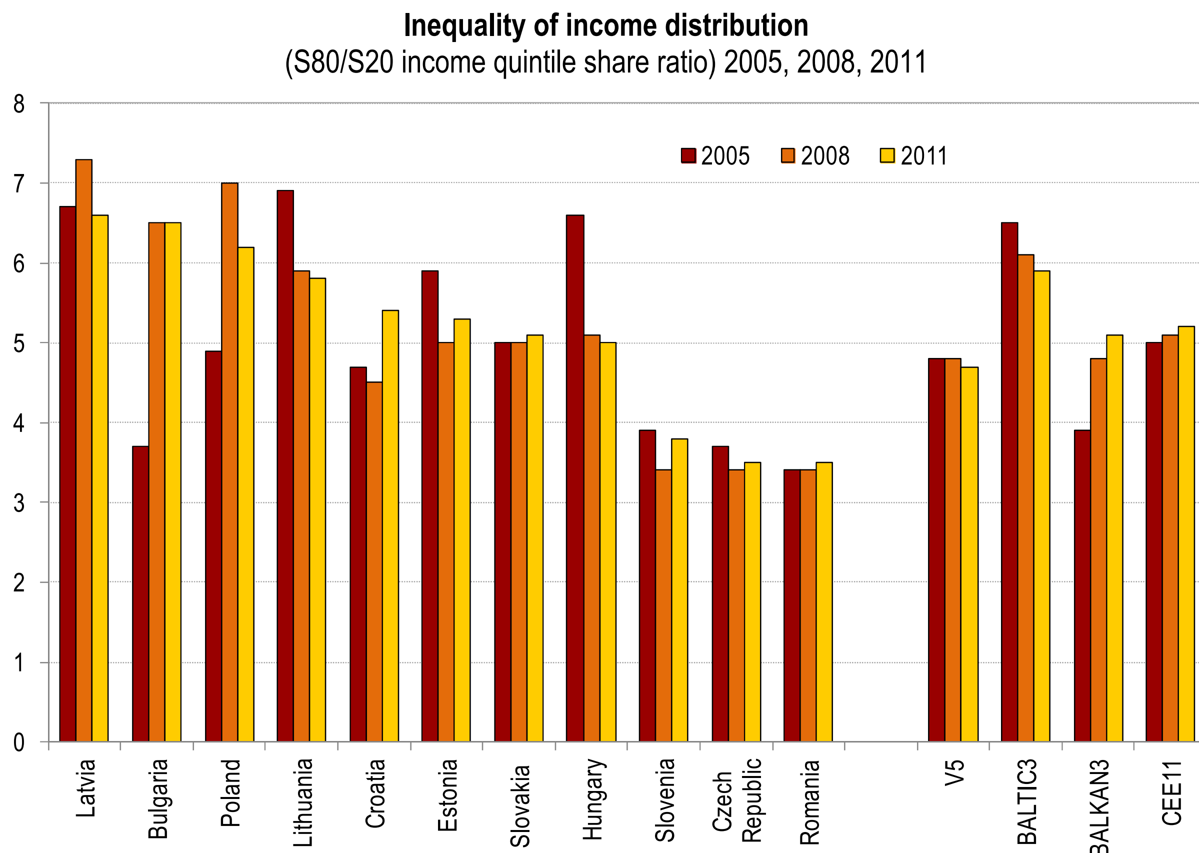
Among the CEE11 countries less than 6% of the target population was living in households with very low work intensity in Czech Republic, Poland and Romania. In contrast, the indicator exceeded 12% in Croatia, while was between 9-10 % in Latvia, Lithuania and Hungary.

4.1.2. Inequalities in income distribution

Wide **inequalities in the distribution of income** were observed among the population of the EU-27 in 2011: the 20% of the population with the highest equivalised disposable income received **five times as much income** than the 20% of the population with the lowest equivalised disposable income. This ratio varied considerably across the member states, in CEE11 countries, from 3.5% in Slovenia and Romania, to 6.5% in Bulgaria and 6.6% in Latvia.

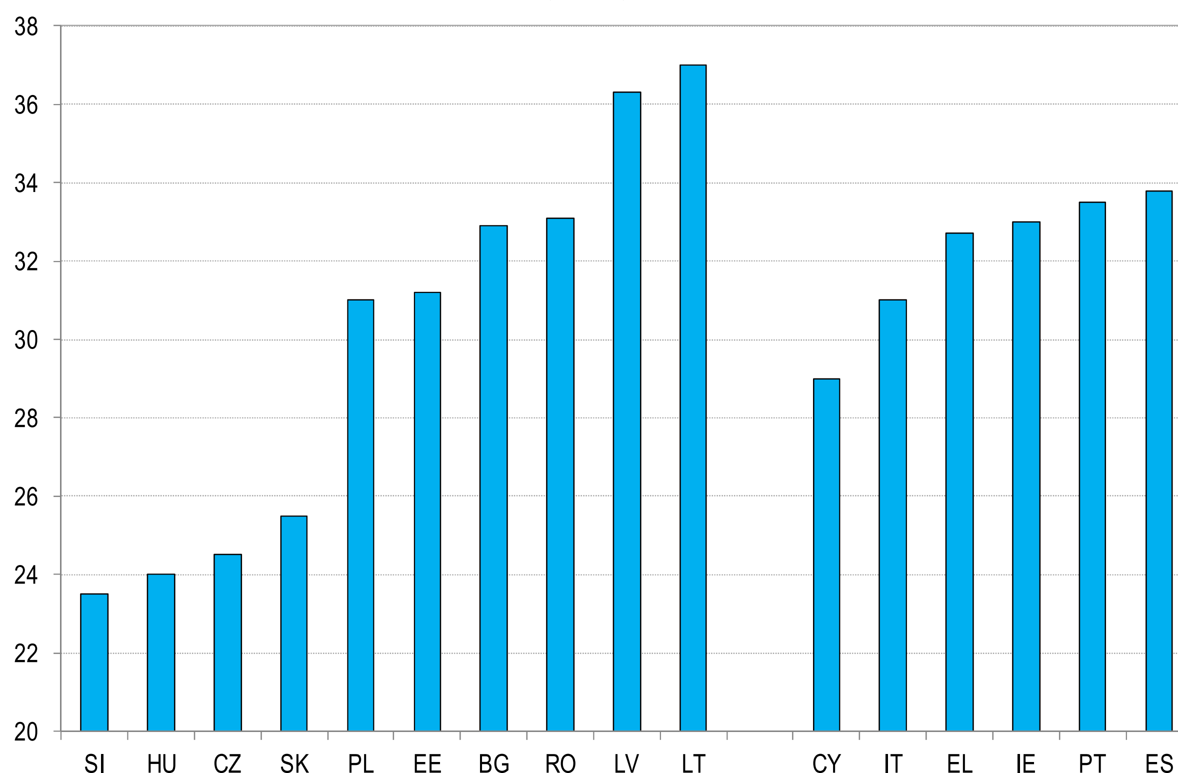
Inequality of income distribution

(S80/S20 income quintile share ratio) 2005, 2008, 2011



Note: The figures of the individual country groups are un-weighted averages
Source: Eurostat

The Gini coefficient measures the inequality among values of a frequency distribution (for example levels of income). A Gini coefficient of zero expresses perfect equality, where all values are the same (for example, where everyone has an exactly equal income). In some of the CEE countries (Slovenia, Hungary, Czech Republic, Slovakia) the Gini coefficient is relatively smaller than in the EAP6 countries, while the highest figures are found in Latvia and Lithuania.



Source: Klara Stovicek (2013)

4.2. Housing

One major element of the quality of housing conditions is the **availability of sufficient space** in the dwelling. The indicator that has been proposed to describe space problems is the overcrowding rate.[11] In 2011, the highest **rates of overcrowding** were observed in Romania (54.2%), Bulgaria (47.4%), Poland (47.2%) and Hungary (47.1%), while the lowest were seen in Estonia (14.4%) and Slovenia (17.1%). The EU27 average rate of overcrowding was 16.9%. These indicators show an improvement for the whole of the societies.

[11] European social statistics (2013)

Overcrowding rate by poverty status
(Percentage of specified population, 2005, 2008, 2011)

	Total population			Population at risk of poverty		
	2005	**2008**	**2011**	**2005**	**2008**	**2011**
Czech Republic	33.6	29.8	21.1	58.8	50.4	41.0
Hungary	49.9	48.3	47.1	65.8	65.7	71.0
Poland	54.1	50.8	47.2	69.1	67.2	62.5
Slovenia	42.0	39.5	17.1	50.7	47.2	26.4
Slovakia	46.6	42.9	39.5	59.9	55.5	55.5
V5	**45.2**	**42.3**	**34.4**	**60.9**	**57.2**	**51.3**
Bulgaria	-	48.1	47.4	-	52.8	54.9
Croatia	-	-	45.1	-	-	48.4
Romania	-	56.5	54.2	-	63.3	66.0
Balkan3	**-**	**52.3**	**48.9**	**-**	**58.1**	**56.4**
Estonia	46.1	41.7	14.4	56.2	44.8	27.1
Latvia	59.8	58.1	44.3	63.5	55.8	57.9
Lithuania	52.8	49.9	19.7	62.3	53.6	27.2
Baltic3	**52.9**	**49.9**	**26.1**	**60.7**	**51.4**	**37.4**
CEE	**48,1**	**46,6**	**36,1**	**60,8**	**55,6**	**48,9**
EU	**19.4**	**18.2**	**16.9**	**31.3**	**29.3**	**28.9**

Note: The figures of the individual country groups (except the EU) are un-weighted averages
Source: Eurostat

However these indicators deteriorated for the population at risk of poverty rate in 2008-2011 in Hungary, Romania, Latvia and Bulgaria.

4.3. Social protection systems

Social protection systems are highly developed in the European Union: they are designed to protect people against the risks associated with unemployment, parental responsibilities, health care and invalidity, the loss of a spouse or parent, old age, housing and social exclusion.

Taken together, government expenditure on 'social protection' and 'health' accounted for 54.8% of total government spending of the EU27 in 2011. The **lowest percentages** of the CEE11 were found in Latvia (42.2%), Romania (44.5%) and Hungary (44.8%), while the **highest** in Slovenia (50.8%), the Czech Republic (49.8%) and Bulgaria (49.1%)

In 2011, compared with 2003, spending by government on social protection and health has an increased weight relative to GDP. Overall, in comparison with 2003, spending in the 'health' and 'social protection' functions as a percentage of GDP increased by 1.8 percentage points in the EU27. **Estonia and Romania were characterised by the highest increase.** On the other hand, government expenditure on health and social protection **decreased in terms of GDP in Bulgaria, Poland and Slovakia**.

General government expenditure on 'social protection' and 'health'
(As a percentage of GDP, 2003, 2007, 2011)

	2003	2007	Difference 2007-2003	2011	Difference 2011-2007	Difference 2011-2003
Czech Republic	21.2	19.4	-1.8	21.4	2.0	0.2
Hungary	21.8	22.6	0.8	22.2	-0.4	0.4
Poland	23.1	20.1	-3.0	20.6	0.5	-2.5
Slovenia	23.5	21.4	-2.1	25.8	4.4	2.3
Slovakia	19.3	17.0	-2.3	17.8	0.8	-1.5
V5	**21.8**	**20.1**	**-1.7**	**21.6**	**1.5**	**-0.2**
Bulgaria	17.7	14.8	-2.9	17.5	2.7	-0.2
Romania	13.5	14.3	0.8	17.5	3.2	4.0
Balkan2	**15.6**	**14.6**	**-1.1**	**17.5**	**3.0**	**1.9**
Estonia	14.0	13.6	-0.4	18.2	4.6	4.2
Latvia	14.2	12.8	-1.4	16.2	3.4	2.0
Lithuania	14.6	15.5	0.9	17.9	2.4	3.3
Baltic3	**14.3**	**14.0**	**-0.3**	**17.4**	**3.5**	**3.1**
CEE11	**18.3**	**17.2**	**-1.1**	**19.5**	**2.4**	**1.2**
EU	**25.1**	**24.3**	**-0.8**	**26.9**	**2.6**	**1.8**

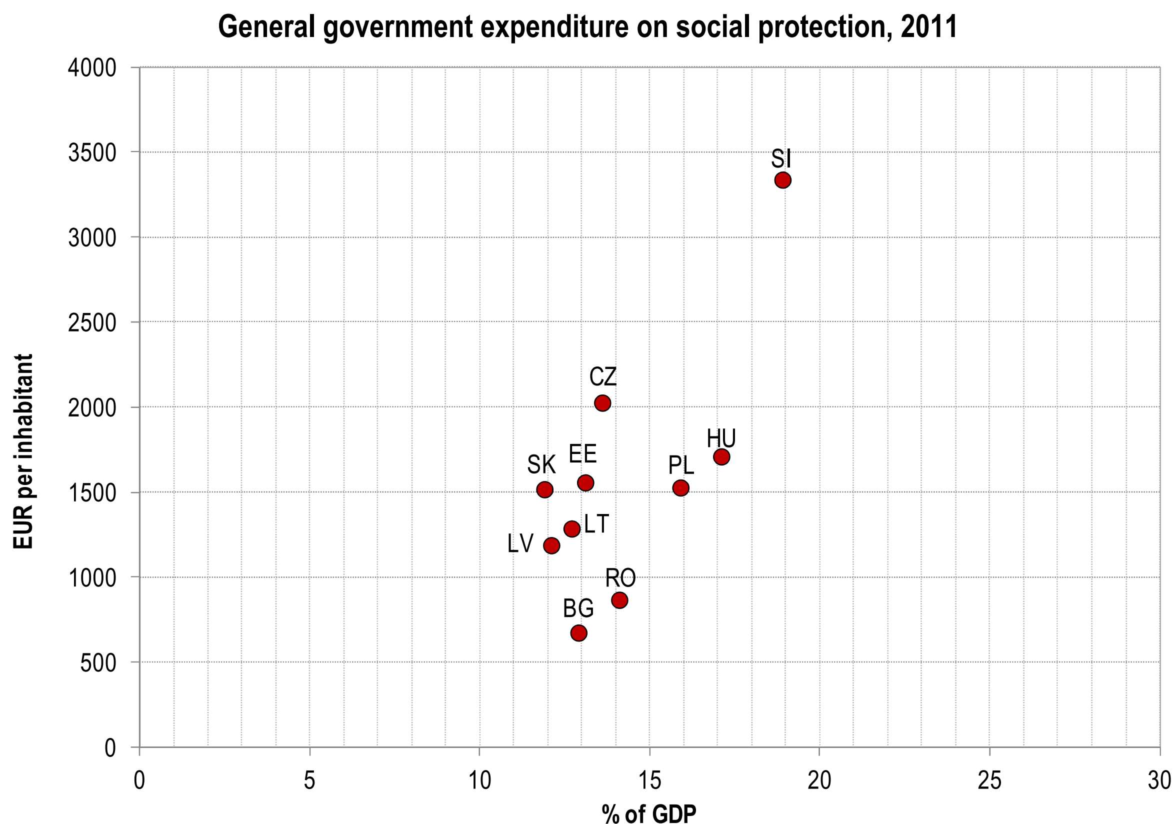
Note: The figures of the individual country groups (except the EU) are un-weighted averages
Source: Eurostat, GKI

4.4. Social protection expenditures

The social protection division includes spending on sickness and disability, old age, family and children, unemployment, housing in the form of benefits in kind, and social exclusion. This function is **by far the most important in public expenditure** and accounted alone for 39.9% of total expenditure or 19.6% of EU27 GDP in 2011. **The lowest expenditure on social protection as a percentage of GDP was found in Slovakia** (11.9%), Latvia (12.1%), Lithuania (12.7%) and Bulgaria (12.9%). The V5 average is 14.2%, higher than the Baltic3 average (12.6%) and the Balkan2 (13.5%).

In all countries the category **old age,** which includes most pension schemes, is predominant and represents at least 40% of total public spending on social protection. All benefits related to **sickness** and **disability** often come as the second group of social protection expenditure, representing 20% or more in Hungary and Lithuania together with the Scandinavian countries, Ireland, and the Netherlands. Other relatively important categories concern benefits to families for dependent children and unemployment allowances[12].

[12] Laurent Freysson, Laura Wahrig (2013)



Source: Eurostat, GKI

4.5. Health expenditures

Health is the second largest function of government spending, at 7.3% of EU GDP in 2011 (14.9% of total government expenditure). This includes expenditure on medical and pharmaceutical products or on equipment intended for use outside a health institution, outpatient, hospital and other public health services and applied research and experimental development related to health. Within the CEE countries, government health expenditure ranges from less than 5% of GDP in Romania (3.4%), Latvia (4.1%), Bulgaria (4.6%) and Poland (4.7%) to 6.9% in Slovenia and 7.8% in the Czech Republic. Here again, this indicator is **lower than the EU27 average for almost all the most recent member states with the exception of the Czech Republic**. As for public health expenditure per inhabitant, figures show a lower dispersion than for social protection.[13] However, smaller amounts are again found in the most recent EU member states. The V5 average is 5.3%, higher than the Baltic3 average (4.8%) and the Balkan2 (3,9%).

[13] Laurent Freysson, Laura Wahrig (2013)

General government expenditure on health by country, 2011

	in per cent of GDP	EUR million	EUR per inhabitant
Czech Republic	7.8	12 145	1 157
Hungary	5.1	5 132	515
Poland	4.7	17 529	455
Slovenia	6.9	2 481	1 209
Slovakia	5.9	4 093	752
V5	**5.3**		
Bulgaria	4.6	1 772	241
Romania	3.4	4 444	208
Balkan2	**3.9**		
Estonia	5.1	813	606
Latvia	4.1	831	404
Lithuania	5.2	1 616	533
Baltic3	**4.8**		
CEE11	**5.3**		
EU	**7.3**		

Note: The figures of the individual country groups (except the EU) are un-weighted averages
Source: Eurostat, GKI

4.6. Social cohesion

Social cohesion is **a relatively new concept in quality-of-life research**: it emerged in the 1990s. The term refers to a specific aspect of a society's collective quality of life: the solidarity exhibited by the people of that society. In exploring the issue of social cohesion, in other words, we are exploring the sense of community that exists in a society. Although studies of **societal well-being** are increasingly looking at a broader range of measures, and not just economic indices, social cohesion is rarely taken into account when comparing wealth and quality of life in different societies.

The term social cohesion has to do with how members of a community, defined in geographical terms, live and work together. A cohesive society is characterized by resilient social relations, a positive emotional connectedness between its members and the community, and a pronounced focus on the common good. **Social relations,** in this context, are the horizontal network that exists between individuals and groups within the society. **Connectedness** refers to the positive ties between individuals and their country and its institutions. A focus on the **common good**, finally, is reflected in the actions and attitudes of the members of society that demonstrate responsibility for others and for the community as a whole. **These are the three core aspects of cohesion.**[14]

According to an international comparison of social cohesion **European countries can be grouped into five tiers**. The scores are used to divide the countries into five colour-coded groups. In the period **2009-2012 countries of the CEE11** are all in the fourth and in the fifth tiers.

[14] Georgi Dragolov, ... (2013)

An international comparison of social cohesion (2009–2012)

Rank	Country	Tier Nr.	1. Social relations			2. Connectedness			3. Focus on the common good		
			1.1 Social networks	1.2 Trust in people	1.3 Acceptance of diversity	2.1 Identifi cation	2.2 Trust in institutions	2.3 Perception of fairness	3.1 Solidarity and helpfulness	3.2 Respect for social rules	3.3 Civic participation
1	Estonia	4	4	2	4	3	3	3	5	4	5
2	Poland	4	3	4	3	2	4	4	4	4	5
3	Slovenia	4	2	5	3	2	5	5	4	3	4
4	Czech Republic	4	3	4	3	5	4	4	5	2	4
5	Hungary	4	4	4	3	2	4	5	5	3	4
6	Slovakia	4	3	5	5	4	4	5	5	3	4
7	Lithuania	5	3	4	3	3	5	5	5	5	5
8	Latvia	5	5	5	4	3	5	5	5	4	5
9	Bulgaria	5	5	5	3	2	5	5	5	5	5
10	Romania	5	5	5	2	4	5	5	5	5	5

Source: Bertelsmann Stiftung, Social Cohesion Radar; GKI

Social cohesion is strongest in Denmark, followed by Norway, Finland and Sweden. The English-speaking non-European countries are next, ranking fifth through eighth. They are followed by relatively small, wealthy countries in Western Europe, as well as Germany, which manages to join the second tier. The middle tier includes three of the major EU countries: the UK, France and Spain. The fourth tier consists of countries of eastern central Europe and the Mediterranean region. **All CEE11 countries are in the fourth and fifth tiers,** with Estonia followed by Poland, Slovenia, Czech Republic, Hungary and Slovakia in the fourth tier, then two Baltic countries (Lithuania and Latvia) together with Bulgaria and Romania **in the fifth**.

If we look at the nine dimensions, we see that in each country, the level of individual aspects of cohesion may vary. Countries with a relatively low overall score for cohesion may do well in certain areas: **Romania, for example, has a considerably higher score for acceptance of diversity than for most of the other dimensions** – and they do better in this regard than many Western European countries. In Poland, Slovenia, Hungary and in Bulgaria **people identify strongly with their country**; they are in the top group for this dimension, despite generally low levels of cohesion. In Slovenia **social networks** are efficient, in Estonia the **trust in people**, in the Czech Republic **the respect for social rules** is stronger than in other countries of the region. **Overall, however, the picture is quite consistent. Social cohesion manifests itself in a similar way in a variety of areas. The CEE region countries are all in the same tier as they were in the period 2004-2008, so the social cohesion could not improve over the time. Cohesion is not something that can easily be changed; rather, it is a relatively constant characteristic of a society.** [15]

[15] Georgi Dragolov, ... (2013)

4.7. Labour market

As it can be derived from Chapter 1, the global **financial and economic crisis hit the CEE11** member states of the EU **more severely than the EACORE, but much less than EAP6 countries**. Many of the CEE11 introduced policy measures to counterweigh the decrease of employment and the pick-up of unemployment during the crisis.

In some CEE countries the adjustment triggered by the crisis included measures that aimed at reforming the labour market. Several countries **liberalised** their labour markets by eliminating restrictions on work arrangements in order to increase flexibility. The **financial sources of EU funds**, as well, were deployed to raise employment. With the exception of Bulgaria, **unemployment benefits were cut** in order to strengthen work-incentives and reduce benefit dependency.

As far as the individual groups of CEE countries surveyed are concerned, **the Baltic3** pursued classical "monetarist" monetary policy in contrast to activist or interventionist one.[16] **Internal devaluation implied practically no government intervention** in the labour market in favour if increasing employment. **Neither passive nor active labour market policies were undertaken.**

In fact, the **drastic fiscal adjustment** in terms of cuts in general government expenditures including the streamlining of government institutions and the **reduction of wages and social benefits** had **adverse effects on the labour market**. E.g., the Latvian government closed down half of its 75 state agencies. 29 per cent of the civil servants (some 23 thousand persons) were dismissed. The average public wage was reduced by 26 per cent in 2009. **Wage cuts in the public sector spilled over to the private sector.**

One sort of response from the part of employees to this policy that led to the drastic reduction of jobs was **emigration** reflecting the flexibility of the Baltic labour market (similarly to that of the Irish one). E.g., as far as **Latvia** is concerned, some **200 thousand people** amounting to **10 per cent of total population** left the country during the crisis years. The pick-up of emigration was a pronounced trend in **Estonia** and **Latvia** as well. However, it should be noted, first, that the trend of **emigration started earlier**, with the accession to the EU. In 2007, almost 300 thousand citizens of the three Baltic countries took jobs abroad. Second, demand for foreign labour force in the developed market economies became rather tight during the crisis, thus **limiting** further emigration. Unemployed people in the Baltic countries could hope for the upturn that arrived relatively soon with rising employment and declining unemployment rates. Nevertheless, the **unemployment rate remained at relatively high levels**.

As a summary, it can be stated that the **experience of the Baltic countries with labour markets cannot be applied in the more developed countries of the CEE region**. First, the **layoff** of employees **in a Baltic** scale would have been **impossible** without strong social protest. The lack of such a protest has its roots in the specific relationship of the Baltic countries to Russia and the former Soviet Union, respectively. Second, the Baltic option of **emigration is not feasible** for more populous member states due to the limited size of absorption capacity and labour demand in the recipient developed market economies.

As far as the **Balkan3** are concerned, in **Romania** several changes were made to the Labour Law in 2011 in order to **increase the flexibility** of the labour market. The trial period was extended, the maximum length of fixed-term contracts was stepped up from 24 months to 36 months, the eligibility

[16] Markku Sippola (2001)

criteria to social benefits were tightened, active measures were elaborated for job seekers, job subsidies were established for companies, etc. However, the **share of public expenditure on labour market policies in GDP has been the lowest in the European Union**.

Romania is famous for the large number of its **emigrant** workers. According to OECD figures, the total number of Romanians working abroad totalled **3 million** persons in 2009. They **transfer some EUR3-4 billion annually** to Romania representing an income source (sometimes the only one) for several other millions in Romania.[17] This phenomenon is explained by the historical roots in the political, economic and social realities of the transition to market economy and partially by the advantage of the Romanian (a Latin) language. Most Romanians do not expect anything from their government. As far as the labour market is concerned, **wages and salaries were cut in the public sector in line with the conditions of the IMF loan**. These cuts exerted **downward pressure on wages in the private sphere** as well. Nevertheless after the crisis the return of many Romanian people working abroad deteriorated the situation.

Bulgaria has focused its attention on a **mix of growth-enhancing labour market policies** targeted mainly at **vulnerable groups** to avoid the build-up of long-term unemployment, to increase **flexibility** in the labour market and to improve the quality of the work force. According to the latest country specific report of the European Commission, in Bulgaria the **labour market is suffering from structural challenges with regional and skills mismatches** that are among the highest in the EU. According to the Commission, **active** labour market **policies** and a **well-functioning Employment Agency** are needed to help people, particularly the young and other vulnerable groups to find a job.

According to OECD figures Bulgaria has been a **net emigration** country since 1992. Over the twenty-year period, **emigration amounted to 6 per cent of total population** and **10 per cent of economically active population**. Bulgarian and Romanian citizens generally **prefer Italy** and **Spain** as their first destination.

In **Croatia employment was decreasing** and the **unemployment rate was increasing** in each year from 2009 to 2012. High unemployment is a **legacy** of the past, emerging from low labour mobility and employment protection legislation. Measures aimed at improving the labour market situation included subsidised employment, training programs, traineeship (work experience) schemes, public work, tax relief and self-employment support. Expenditures on these active labour market measures were less than 0.1 per cent of GDP from 2008 to 2012. **In terms of quality, they were not suitable for improving the skills of those involved.**

As far as the V5 group are concerned, the only country that avoided recession in 2009 was **Poland.** Therefore, the Polish example is rather unique in the CEE region. **The Polish government did not have to introduce counter-cyclical labour market policies** to ease the negative effects of recession on employment. It did not invest to support the labour market. Nevertheless, prior to the global crisis **the taxes and duties imposed on labour on the part of employers were reduced somewhat** with positive effects on employment trends during the crisis. The labour market situation has been eased by the fact that according to estimates by the Research Institute ARC and the Polish Central Statistical Office, the total **number of Poles working in EU countries was over 2.2 million in 2010**. The majority of them were located in **Ireland** and the **United Kingdom** (over 1 million) and **Germany** (over 400,000).

[17] Diana-Mihaela, POCIOVĂLIŞTEANU (2012)

These figures refer only to polish citizens registered in the host countries; the actual figure for Polish labour migrants is likely to be much higher.[18]

Nevertheless, with the slowdown of the rate of GDP growth and the return of many Polish people working abroad, the **rate of unemployment mounted**. The major policy measure affecting the labour market is that from 2013, the **retirement age will be gradually raised to 67 years for both men and women** from the former 65 years (men) and 60 years (women). Licensed professions will be liberalised enabling access to them.

Although the **Czech Republic** was relatively moderately influenced by the global financial and economic crisis, its government introduced **anti-cyclical policy measures**. They included a **rebate on social security contributions** to promote the employment of low and middle-income people and to avoid mass lay-offs. The social security contributions for **self-employed** persons were slightly reduced and so were the **unemployment benefits** in terms of both payments and duration. **Retraining** programs, as well, were initiated and implemented.

As a response to the challenge of the global crisis, **Slovakia** took a set of measures to manage the crisis in terms of mitigating recession and preserving jobs. The most important elements of crisis management in the labour market included the introduction **of public support for flexible working time, a training scheme for unemployed,** the **reduction of social security contributions by self-employed**, some changes in the tax and benefit system and the subsidization of **job preservation** and **job creation** through various schemes. The work commuting allowance was raised as well.

The labour market policy in **Hungary** bolstered the **preservation of existing jobs** and labour demand during the years of the crisis. In line with these objectives several more or less comprehensive labour market programmes were launched and implemented. **Employers' social security contributions were cut first generally and later selectively.** Currently the government intends to encourage **job creation among the SME's**, the relatively more labour intensive segment of the Hungarian business sector. A new tax system for small and micro-sized enterprises was introduced in terms of a **cash-flow** income tax for small enterprises and a **lump-sum tax for individual entrepreneurs to diminish the tax burden**, although to reaction of the ventures was modest. In terms of **emigration** Hungary is an **exception** to the general trend since the **outflow of migrants intensified only in the past** 2-3 years and thus contributed to the **easing of labour market tensions**. According to different estimates about 0.4 million Hungarians work abroad in EU countries.

The **most controversial measures** introduced in **the Czech Republic, Hungary and Slovakia** included **subsidised job creation schemes in the public sector** in the specific form of Institute of Public Service (Czech Republic) and public workfare programs (Hungary). Nevertheless, **these programs are not suitable for creating sustainable jobs**. They seem to be **temporary second best solutions**. They appear to substitute unfocused fiscal stimuli. They raise the number of public workers and thereby **increase artificially the statistical number of employees and reduce the statistical number of the unemployed, even if the actual labour market situation does not really improve**.

In **Slovenia** the main goals of the proposed new Labour Relations Act include the provision of appropriate relationship between job security and labour market flexibility. Another objective is to reduce the differences in rights arising from different forms of contractual agreements and by **limiting the grounds for the use of temporary employment contracts**. The Act intends **to ease the transition** of

[18] Bertelsmann Stiftung (2011)

workers **from flexible to more stable forms of employment**. Notice periods will be shortened and raised progressively up to a certain limit. Severance pay will be cut back. Procedures for the conclusion and termination of employment contracts will be simplified and so will be disciplinary proceedings. All these measure are likely to **upgrade the effectiveness of labour protection legislation**.

The gradual expansion of **women's employment** in CEE11 has stopped and gender differences still remain. While the gap in unemployment rates between men and women has largely disappeared since the beginning of the crisis, many member states show **no signs of closing the gender pay gap** and women still face higher risks of poverty or exclusion than men. Specific labour market trends help explain this apparent paradox – part-time jobs, a traditional domain of female employment, have been the only labour market segment continuously expanding even during the crisis, thus optically improving the labour market situation of women, but with only a limited impact in terms of income gains.

While **long-term unemployment has increased** in most member states in recent years, affecting more severely specific groups, such as men, young people or low-skilled workers, predominantly those employed in declining occupations and sectors. Looking at the most recent available data on transitions, inflows into unemployment have returned close to pre-crisis level, but return rates to employment remain diminished for both short and long-term unemployed. The economic cycle remains a powerful factor explaining changes in levels and flows to and from long-term unemployment, but there are also strong country effects whereby some countries ensure high transition rates back to employment thanks to good policy mixes, in contrast with others which are less successful in this respect (for instance Slovakia and Bulgaria). Particularly in countries where temporary contracts play an important role, repeated multiple spells of short-term unemployment are also a widespread phenomenon.

As a **summary** it can be stated that **because of budgetary restraints there was rather limited fiscal scope for robust Keynesian-type anti-cyclical labour market measures in the CEE11 countries**.. The various programs aiming at the preservation of existing jobs, the creation of new ones by different means, etc. launched during the crisis **could not reverse negative labour market trends**. Nonetheless, they **might have contributed to the mitigation of the worst effects caused by the crisis**. At the same time **due to wage decreases they intensified social tensions**.

The global financial and economic crisis enforced the majority of the CEE countries to introduce different types of reforms, as a result of which the **regulation**, the **flexibility** and to **some extent the structure** of their labour markets turned closer to that of the well-established and fully fledged market economies of the EU. **Paradoxically, the flexibility of the labour market improved the most under the pressure of the shock therapy in the Baltic countries.**

Prior to the crisis, emigration, that was encouraged by the accession of the CEE countries to the EU in 2004 and 2007, respectively, certainly eased the tensions in the labour market and involved other short-term advantages for the sending countries (in terms of remittances, etc.). **With the crisis, the return of guest workers constituted additional pressure on the labour markets.** Hungary was an exception to this rule.

The European Commission identifies three areas in which we are witnessing the dawn of a new era in the construction of social Europe, and this, despite the fact that social issues are the responsibility of national governments: **youth unemployment, mobility and macro-economic stabilisation**.

The European Commission adopted a Social investment package on 20 February 2013 for the purpose of fostering growth and cohesion. The aims enshrined in the proposal rest on three major points:

responding to people's needs at critical times in their lives, with the focus on investing early and preventively; spending more effectively and efficiently to ensure social protection is adequate and sustainable; some countries manage to achieve better results than others with a budget at the same level or lower, which proves that it is still possible to improve efficiency in the sphere of social spending; investing in people's skills and capacities to improve people's opportunities to integrate in society and the labour market. Examples of this are education, childcare, healthcare, training, job-search assistance and rehabilitation. The package is well designed for CEE11 as well.

5. The growth and convergence perspectives of CEE11

Present chapter analyses the convergence perspectives of CEE countries **not simply** on the basis of a **number of economic, financial indicators**, but in a **more complex way**. On the one hand, it embeds the process into the context of **changes in the whole of the EU;** on the other hand, it puts the emphasis on the qualitative factors of convergence, on the **characteristics of the operation of the socio-economic institutional systems which determine competitiveness**.

It has been an **important goal of the EU, from the beginning**, to even out the different levels of development of EU member states. All EU documents assess the path of development of new member states not simply from the point of view of development, but also from that of convergence. This follows from the fact that it has been the most important hope of the citizens of CEE countries concerning the regime change that their **quality of life** would converge to that of the developed Western countries within a relatively short period of time. **In the past decade** they have made substantial progress in this: with the only exception of Slovenia **the GDP at purchasing power parity per capita of all other CEE11 states compared to EU average increased.** (This improvement was partly due to the deep crisis in certain Southern European countries, which pulled down the EU average.) However, the **differences** are also important. Between 2003 and 2012 the **Baltic3 countries**, as well as a part of V5 countries – **Slovakia and Poland** – showed a spectacular, **20-25 percentage points rise**. **Bulgaria** and **Romania,** which became members later, also improved their performance, though more modestly. However three V5 countries – the **Czech Republic, Slovenia and Hungary, which otherwise were the top performers in the region in 2003** –, could only improve by 5-10 percentage points. (Nevertheless, Slovenia and the Czech Republic remained top performers.) The successful countries include both large and small, EMU and non-EMU member economies. **The process of convergence was stopped from 2008 by the global financial and economic crisis.**

Because the GDP as an indicator centres primarily on the economy, in the past decades other indicators have also been created aimed at measuring economic and social processes in a more complex way. **The situation of CEE11 countries has also improved when measured by the Human Development Index.** This indicator compares countries on the basis of life expectancy at birth, the cultural level of the people, education, the standard of living and the quality of life. In this order in 2012 **Slovenia held the highest rank** – followed by the other V5 countries and Estonia, with the other two Baltic countries and the Balkan countries were placed further back. Based on 2005 data as well, Slovenia was best placed from among the CEE11, but since then the Czech Republic advanced five places in the international ranking, and in 2012 was already in the first 30. Hungary, however, even fell back one place between 2005 and 2012.

Recently, besides examining the welfare of the society, the **well-being** of the society has also become a topic of analysis. This takes into consideration among others **income distribution**, the **quality of public services**, the **burdening of the environment** and even changes in different **subjective factors**. According to an analysis of the **„Social Cohesion Radar"** (Bertelsmann Stiftung, 2013) **social cohesion** – which is measured among others by trust in institutions, the perception of correct behaviour of social actors, the extent of equality in accessing public goods, the characteristics of relations between social groups – **is very closely related to how satisfied people are with their life.** The analysis shows that **the weakest social cohesion (and satisfaction with life) may be found in CEE10 countries** (and in Greece and Portugal), while **within the CEE region** the situation of the **V5 countries** – excepting Hungary – is the **most favourable**. The **cohesion** characterising the individual countries **changes only slowly**. Further research found that though income movements are not parallel to changes of the satisfaction with life, for those who got into a disadvantageous situation in the past or are

expecting a deteriorating financial situation in the future, satisfaction values are also lower. **Thus, it is not the actual income but the feeling of existential security and the financial situation that are decisive in the question of satisfaction!**

5.1. Changing European priorities

The perspectives of CEE11 countries are inseparable from the future of the whole of the EU. What started out as a financial and economic crisis has become a social and political crisis involving a crisis of cooperation and solidarity as well in the EU. Fundamental problems of the EU (see Blueprint) are unresolved, cohesion has loosened and increasing social inequalities have also contributed to the deepening of the crisis. Decision processes are slow. According to public opinion polls the majority of the population likes the euro, but does not like the EU. The reforming of the EU cannot be postponed.

The crisis within the EU has restructured the priorities of the integration organisation and the member states. Ensuring the stability of the EU, the euro and the individual member states has become a top priority, as compared to convergence. As the converging countries have been busy with crisis management, equilibrium targets have gained priority as compared to growth targets, and the individual countries are having problems finding the new sources of growth or have been completely unsuccessful in doing so. It has gradually become clear that, after the period of fire-fighting, more attention should rather be paid to preventing further equilibrium disorders and to initiating growth, as well as to social aspects. Without sizable growth even the equilibrium problems cannot be solved in a long term perspective. This involves partly the substantial "correction" of the EU, of its system of institutions, decisions, responsibility, and partly the improvement of the competitiveness of the individual national economies.

Already before the accession of the CEE countries, the EU was under the **double pressure of globalisation**. Structural adaptation was forced, on the one hand, by the challenge posed by the oppressive technological, financial, political dominance of the US, and on the other hand, by the competition of the emerging countries based on their cheap labour. The enlargement of the EU – the extension of its trade and investment markets – was also a part of this process. In the context of the restructuring of global economic and political power relations **the weight of the EU is decreasing**, and the impediment of this process requires the transferring of a substantial part of the traditionally national state competencies to the EU integration level. A third, likewise global challenge also contributes to this: ensuring of the **sustainability** of the processes. This requires the treatment of the financial, macroeconomic, social and mental crisis. Thus, sustainability shall not only be regarded from a financial or even environmental aspect, but as the professionally well-founded and democratically legitimate treatment of the aging society, the social problems, as well as the diverging nation state ambitions. Growth shall be realised in the context of structures that can be financed and are competitive in terms of supply, that take into consideration social and ecological problems, that respect well-being in a broader sense, and that harmonise the interests of the whole of the EU and of the individual countries.

The EU shall find a solution on the basis of its own values to the unavoidable problem of the reforming of the social market economy. It shall optimise the rather different requirements of **subsidiarity**, **solidarity** and **competitiveness**, and as these involve not a zero-sum game but a positive or negative spiral, it shall try to **initiate self-reinforcing positive processes.**

Reforms in the EU are being **forced by four basic processes** which have evolved in the past decades – **globalisation, integration, regionalism and the transformation of the economic role of the**

nation states. The EMU and the EU shall proceed in the direction of the **banking union**, **fiscal and political integration**, and the **more intelligent coordination of national economic policies**. **This shall involve the complete democratisation of its whole system.** Making use of the energies of the cross-border **organic development of regions** may upgrade the role of competitive micro- and macro-regions. This represents a new possibility especially for small CEE member states. Though this may **limit the independence of nation states**, if they do it well, they may produce real **European Added Value**. However, the **nation states have a decisive role** in promoting the main factors of competitiveness: in ensuring the complex, efficient development of human capital, modern investments, special local advantages and good infrastructure, and thus, in forming an economic policy ensuring better education and training, retraining, incentives for innovation, and quality labour force.

The great challenge for the EU of whether to proceed in the direction of a kind of "soft" **United States of Europe** naturally divides the societies and governments of the CEE11 countries as well. As due to historic reasons nationalism is rather strong in the majority of these countries, **there is a significant camp among them of the standpoint supporting national sovereignty**. Nevertheless, the approach countering this with the concept of a unified Europe is also strong. Because of their size and afraid of the decrease of their bargaining power (e.g. EU funds), Central European countries – excepting Poland – **fear** a strong central government.

As a result of the European financial crisis, previously unthinkable steps have been taken in the direction of the „denationalisation" of economic policy – **from national competency towards a European level technocratic control**. The new regulations intend to force national governments to become more committed to competitiveness and fiscal discipline in order to regain the trust of the markets and to prevent the breaking out of another crisis. The developed institutional system is based on the imposition of **penalties** and on **voluntary compliance**. It is possible that the **EU administration is able to phrase an efficient economic policy programme based on the best international practices, however**, it is a great question that who will be **able to implement this in the individual countries**. Namely, according to experiences **only a reform policy based on internal commitment** may bring a long term solution to the imbalances. And this shall involve a **high level credibility of the political elite,** for it to be able to phrase **long term credible commitments**. **In case this is missing**, the **sacrifices** required by the reforms **will not be acceptable to the majority of the society**, which will result in the reforms getting stuck. **Some of the CEE11 countries (e.g. the Baltic countries) have been able to develop and implement long term reform programmes.**

By 2013 the **risk of the falling apart** of the euro zone has become minimal, the number of euro zone members does not decrease but increases. Financial stability has been reinforced (with the ESM, the commitments of the ECB, the banking union under construction), and fiscal corrections are also under way in the member states. The **easing of financial tensions is not yet reflected in the real economy,** growth is only getting started slowly and is fragile, differences between the member states are increasing and unemployment is high. The EU – and within it the vast majority of the CEE11 countries – is fighting with structural and competitiveness problems.

Crisis management **cannot be exhausted in restriction;** however, **any solution omitting that is hardly possible**. The main idea is **smart crisis management**, the identification of such means of improving equilibrium which **slow down growth to the smallest possible extent and for the shortest possible period of time**. This implies that **measures which are destructive to the business environment and desired investment (e.g. direct tax raises) shall be avoided as far as possible**, while the reduction of expenditures shall be accomplished to the greatest possible extent by **structural reforms**, and the more efficient operation of state institutions. (Across-the-board type of expenditure

reductions in sectors essential for future development – for example in education – shall be avoided.) Instead of freezing the structures, rapid adaptation shall be promoted. This implies an economic policy supporting retraining and innovation in competitive sectors. The **temporary restriction of the nominal increase of wages and incomes**, and the resulting slight decrease of real incomes is **usually unavoidable**. However, if crisis management and the reduction of fiscal expenditures or business costs is **exhausted in this**, that leads **to a downward spiral**. It is an **even worse solution** if the **restrictions directly affect the business sector (e.g. by direct tax rises)**, as they will, firstly, pass on the burdens to the household sector and, secondly, they will become uninterested in development, and thus, economic growth will lose its driving force.

Governments shall create a tax, education and financing environment which may serve a good basis for the development of higher value added and thus, higher wage-content activities.

The **Euro Plus Pact** helps the harmonisation of the aspects of economic policy that are necessary for the harmonisation of the economic policy of euro zone member states. Non-members of the euro zone may freely decide about accepting these. Joining Sweden and United Kingdom, Hungary was the only CEE11 country which did not accede to the Pact. (Hungary referred to not agreeing with the harmonisation of the bases of the corporate tax, but in reality the source of this decision was that it would have been embarrassing to declare that it holds an opposing position and carries on an unorthodox behaviour in almost all domains.) The regulations of the Euro Plus Pact may be listed in **four groups**. The first is **competitiveness**, in the context of which member states monitor wage policy so that it harmonises with productivity. The second is **employment,** primarily the reduction of long term and juvenile unemployment and for this purpose making more flexible the regulations for lifelong learning programmes (retraining) and employment. The third is the improvement of the **sustainability of public finance systems**, which means among others moving in the direction of pension systems based on individual retirement savings schemes. (The Czechs are moving in this direction, the Polish are in the process of undoing their system, while the Hungarians have practically completely eliminated their system of private pension funds.) The fourth is the reinforcing of **financial stability**, the management of bank defaults, the monitoring of the debts of banks, households and the corporate sector. Besides these, member states also make efforts to coordinate their **tax policies**.

The **EU's AGS** centres on **growth-friendly fiscal policy, the restoring of normal credit policy, harmony between growth and competitiveness, the treatment of unemployment and the modernisation of public administration.** According to the experiences, the key to success is the harmonisation of wage policy with competitiveness, and the reform of social systems, of the pension system and unemployment benefits. According to the proposal, countries should invest in **education, innovation** and **infrastructure**. These ideas in themselves are easy to support. Only it is not clear: from **what, when** and **how** the regulation of the **business cycle** will be developed to **involve** the important tasks of the **common European pension system** and **unemployment benefit system**.

As the rise and fall of societies is not solely an economic, but also a social and political process, the **rise** of our societies has **social and political preconditions**, while their **fall** is due primarily to **political, government failure**. According to experiences, **economic policy supporting convergence** – building a social market economy, oriented at successful, sustainable growth, involving crisis management based on reforms and social sensitivity – could be present in the case of both **right and left wing** governments, with either a strong or a weak majority. The **opposite** of this is the **populist** economic policy, which concentrates on "easy" steps bringing short term popularity, and which is also independent from the political side. In this respect, the **European Commission** shall confront the individual governments. Besides this the **individual factions of the European Parliament also have a great**

responsibility in helping the parties belonging to their political groups in finding the way corresponding to their common values.

The **affinity to populism** of the vast majority of the new CEE11 democracies – especially the substitution of long term solutions with false replacements or with scapegoats – **is similar to or even surpasses that of the Mediterranean countries.** Nevertheless this process also has a **cyclical character**: when the populist economic policy exhausts the economic reserves and confronts with equilibrium or growth problems, it usually **starts a period of modernisation,** or is forced to yield its power to a political force promising this (as well). And the other way around: the **society, exhausted in modernisation, falls for populist promises again and again**. This is naturally a characteristic of democratic multiparty systems; however, the **amplitudes of the oscillations** are greater in CEE as compared to those experienced in more mature democracies.

5.2. The CEE model

Within the EU, the evolved model characteristic of the CEE countries brought significant development. However, this model also has constraints which, without further changes, make doubtful the general convergence to the level of the old member states. The underdeveloped level of education, research and development, innovation, together with the relatively low level of domestic capital accumulation and the decreasing population makes it probable that the transition to an innovation led economic development targeted by the EU's strategy, for the time being, may only be successful in a minority of the countries, rather as an exception.

According to the typology developed in economic literature based on empirical trends, within the EU an **Anglo-Saxon**, a **Northern**, a **Continental** and a **Mediterranean** model could be identified, besides which we may list a fifth, **CEE** model, as the **similarities** between the countries belonging to this group are **greater than the differences**. The purpose of typifying here is the exploration of the characteristics of **competitive institutional systems**. The signs show that it is the **Scandinavian welfare system** that proves to be the **most favourable**, where high public expenditure is balanced by successful reforms, innovation efforts, intensive competition accepted on the goods markets and flexibility on the labour market. **Germany** (or even Austria, and The Netherlands) also moved to a more favourable growth path by freeing the labour market from its rigidities. On the basis of their **successful reforms** these countries are on sustainable growth paths, and **from the point of view of successfulness may represent an alternative to Anglo-Saxon type capitalism**. This is **attractive** as they correspond better to European traditions and to the **social democratic approach**. Nevertheless, it is obvious that while these experiences are important for other EU members, taking any one of their elements and **implanting it** into another model can hardly be successful alone. For example, we cannot abstract from the exceptional resistance of the Scandinavian model to corruption, which is obviously not only a question of resolution, but is a **deeply cultural element**.

The global financial and economic crisis has somewhat restructured the above models. Both in the euro zone and in the non-euro zone a "Northern" (successful) and a "Southern" (unsuccessful) group emerged:

EMU	North	FI, DE, NL, AT, EE, LV, SK, LU, B, F, MT
	South	EL, CY, PT, ES, IE, IT, SI
Non-EMU	North	UK, DK, SE, LT, PL, CZ
	South	CR, HU, RO, BG

From among the CEE11 Estonia, Latvia and Slovakia are in the well performing group within the euro zone, while Slovenia belongs to the poorly performing countries. Outside the euro zone, Croatia, Hungary, Romania and Bulgaria are also characterised by a rather poor performance, while Poland and the Czech Republic show more favourable results.

The characteristics of the evolved CEE model are closely related to the **traits** shown at the time of the **regime change.** The shortage of capital made it necessary to increase **foreign direct investment**, while weak competition on the domestic markets implied liberalisation. The weak positions of the civil society and the **trade unions** left their marks on **labour relations**. Employer-employee relations show relatively limited conflicts, the **labour market is relatively flexible**. (Without European law harmonisation the position of employees would probably be even weaker.) From the point of view of social protection, a lower than EU average level of social expenditures and **marked income inequalities** were typical. **State services** are of extremely **poor quality and unevenly accessible**. In education, the share of those with medium level education was the highest, while the share of those studying in higher education is somewhat lower than the EU average, with education expenditure on the whole being below the EU average. Furthermore, the **weak innovation system** was a direct consequence of the fact that the base of **domestic,** but internationally competitive companies was missing or at least very **weak** in all these countries, while these are usually the engines of innovation. This shortcoming could not be compensated by state induced R&D. Nevertheless, **the paths of the individual countries were different in the course of the two decades**.

The fact that by 2011 the exports of almost all of the EU member states – including those in CEE11 – had exceeded their 2008 level shows clearly how **short-sighted** those prophecies were which, based on the dramatic contraction of world trade in 2009, concluded that it was time to **return to the national markets**. By this time **exports** – even for countries with a large domestic market – had become a **determining growth factor**, especially where there was no recovery on the domestic market. However, it is very telling that while between 2008 and 2011 **intra-EU exports** expanded **only by 3.2%**, exports **to third countries grew by 17%**. This is true for all EU member states with the exception of three countries: for Romania and Bulgaria, which profited from EU membership only from 2007, and for Slovenia, which had significant exports to these countries already previously. While the **dynamics of extra-EU exports is also one of the proofs of EU competitiveness**, the rather modest growth rate of intra-EU exports – though still more dynamic than the GDP growth – shows the weakness of demand in the EU domestic markets.

The global crisis amplified to a certain extent **national isolationist and protectionist tendencies** in numerous EU member states. The point of reference was mostly the protection of employment, which sometimes curbed the improvement of competitiveness in some developed member states, **slowed down** the efficient regional restructuring of industry, and the development of international competition in the domain of services. Thus, the **natural economic expansion of new member states was hindered.** While the business sector remained relatively open and refrained from protectionist moves, the **majority of European societies apparently became inwards oriented**. Eventually, **in spite of the rather widespread anti-capitalist and anti-globalist opinions, hitherto the European market economy could ensure the free movement of goods and factors of production, while also maintaining the diversity of its societies in terms of languages, culture and way of living.** The best proof of this is the existence and development of the newly acceded and viable small member states.

The increasing of employment requires quality growth. The depreciation of **work requiring a low level of professional training and producing small value added** – its relocation to low-wage

countries and its substitution with capital – **continues**. Professional knowledge which due to modernisation is no longer competitive in the old member states may mean progress in the low-wage and lower professional culture environment of the new member states. However, **harmony between the costs of employment and the productivity of labour is crucial**, as **unreasonably high wage levels cause un-competitiveness**. Though in many respects it is more advantageous if capital moves to labour (families are not separated, subsistence costs are lower, ethnical conflicts are fewer, etc.), in some cases it is the mostly well-trained groups from CEE11 that migrate to Western Europe.

With foreign direct investments CEE countries acquired developed technology, and in their product structures the share of products representing high technology augmented, however they usually gained access only to the **lower value added elements of the value chain**. The situation is similar in the case of establishing businesses of foreign suppliers in these countries. This **raises** the competitiveness of the receiving country, however **at the same time it also limits** the innovation output.

The relocation to CEE11 of activities that could be efficient in this low-wage and low professional culture environment also increases the competitiveness of the whole of the EU. Nevertheless, according to surveys oriented at multinational companies, **even in Central European member states it is no longer low wages and state subventions that are most attractive**, but **human capital**, the available **innovative labour**, **good transport and telecommunication infrastructure**, **supplier networks that are under construction**, and **favourable geographical location**, as well as belonging to the European time zone. Naturally legal security, constructive, trustful relations between the economic agents is also preconditions. All this **appreciates** the culture of cooperation in the societies. However, **positive results in innovation would also require a mass of local firms capable of this**, while this – just as the helpful socio-economic environment – is **typically missing**.

Thus, foreign direct investment, the presence of multinational companies is a **necessary but not sufficient condition** of the **transition to an innovation led development** that is indispensable for convergence. Economic policy that targets convergence shall answer the question of how a model capable of involving foreign direct investment could be complemented by policy measures that would enable a **domestic-based, innovation led economic development**. These enterprises shall be able to introduce new technologies and to be competitive internationally. Unfortunately, the vast majority of CEE countries will not be able to step into this phase of development in the foreseeable future.

5.3. Competitiveness, innovation

The correct and comprehensive evaluation of the performance of a national economy is only possible on the basis of the **simultaneous** and joint utilisation of a set of **development, competitiveness and financial indicators**. Capabilities that influence competitiveness do not arise or pass away all of a sudden, they build up or down gradually. **From this aspect, CEE countries have to work off a backwardness of many decades**.

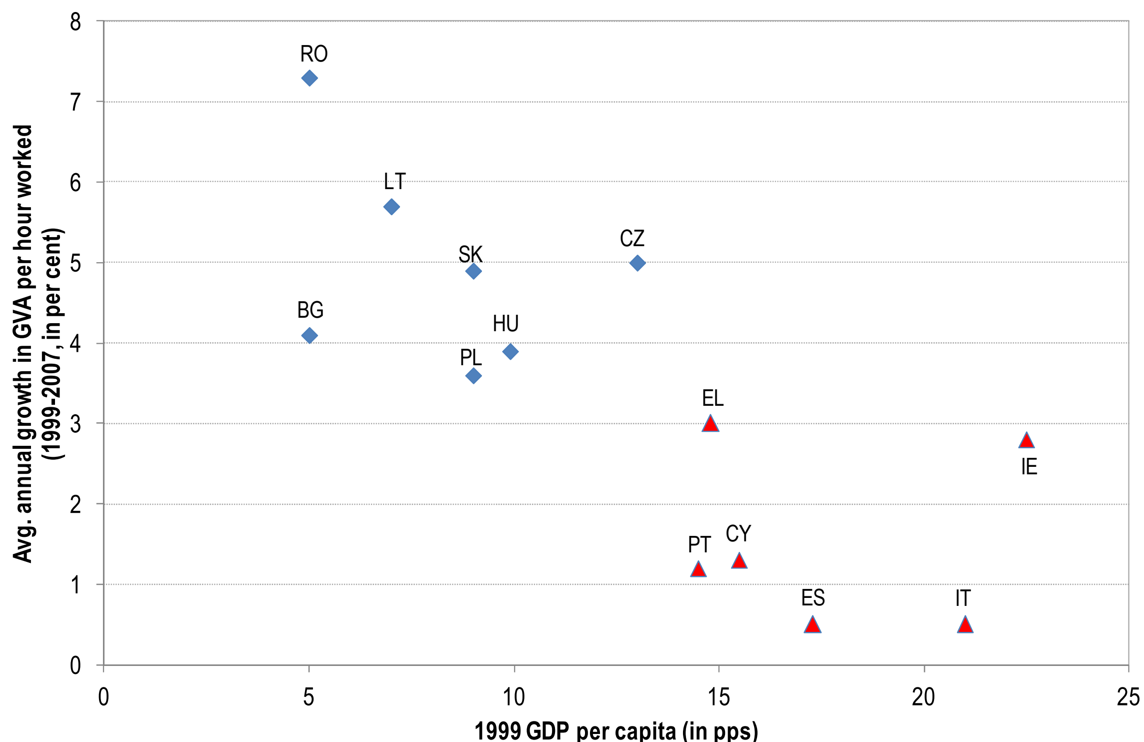
Smart government policy shall serve the **building up of capabilities, and through these, the development of social welfare**. This shall not necessarily take place in the context of a spectacular action plan, rather concentrating on **spheres that have long term effects** – like for example **education**. The phenomenon that short term interests come to the forefront is caused by the impatience related to political cycles. To avoid this, programmes shall contain a diversity of social and cultural elements, and shall rely on the broadest possible **social support**. Coming from the dynamic character of competitiveness, the programmes shall be centred on the development and the utilisation of the mental capabilities of the societies. **In everyday terms this implies that a key role is played by**

education, research, knowledge development and, in sum, the innovation processes. Broadly conceived sustainability is an organic part of the competitiveness policy.

The basic questions of the operation of the economy are to a great extent of **institutional character**. **Transparent, impartial**, stable and professional institutional structure, as well as the rule of law, all is indispensable preconditions of competitiveness, the extent of the realisation of which is decisive for each country. The efficient coexistence of **clear state regulation** and a **flexible market** is necessary. **The state can only be a credible actor if it lives up to its real capabilities.**

On the basis of the dynamic analysis of the **World Governance Indicators** of the World Bank, in the ranking of the Central and Eastern European countries within the full list regarding the **quality of governance,** in the period between 2002 and 2011, the **Czech Republic**, **Poland** and **Slovakia could advance four places**, **Lithuania also improved its position**, the previously top performer of the region, **Estonia**, as well as **Croatia** and **Latvia** improved likewise, the position of the worst performer of the region, **Romania did not change**, while the position of **Slovenia, Bulgaria** and **especially that of the 2002 top performer among the V5 countries, Hungary, deteriorated**. The majority of CEE11 countries increased their total economic performance while also improving the quality of their governance, whereas **deteriorating governance activity was typically characteristic of countries that at the same time were failing economically in many regards. Estonia and the Czech Republic significantly approached** the level of **developed EU member states from the point of view of governance as well**, while the main failure here as well was shown by Hungary. Hungary and Latvia are already positioned, from this aspect as well, somewhere halfway between the V5 or the Baltic3 countries and the Balkan3. Within the EU, **besides convergence we may also perceive divergence** – not only in the case of CEE countries –, which means that in spite of the common legislative and regulatory environment there are **significant differences in customs, norms, forms of behaviour**. This makes it difficult to transform the institutional system, and to proceed to fiscal and political union.

GDP per capita in level and labour productivity growth, CEE7 and EAP6



Source: Quarterly Report on the Euro Area (2013)

Receptiveness and capability of innovation are influenced by numerous factors, from cultural traditions to government policies. Consequently innovation activity mirrors more or less authentically the social and economic state of a given country. If a country shows poor innovation activity for a longer period of time, it may be supposed that this is not simply the result of the weakness of the government's innovation "strategy", but is due to the fact that **neither the factors compelling, nor those inciting innovation are working with the necessary intensity**. Though in every country there is a small part of the business sphere that is innovative, their activity is hardly related to the government's innovation "strategy" but much rather to the capabilities of certain individual creative personalities to find market possibilities and their willingness to take risks.

While governments in CEE11 drew up mostly promising innovation perspectives in their "strategies", the specialised policies affecting innovation activity – thus, fiscal and monetary policy, educational, and public health policies, competition policies, etc. – created a distinctly **unfavourable environment** in numerous countries for this activity. The driving force of innovation is competition. This works well if as a result of competition: **both failure and success actually depend on the performance of the enterprise and on the judgement of the market**.

In numerous CEE11 countries – among others on the basis of the analyses of the OECD – it was clear already before the regime change, that it was necessary to perform a restructuring based on qualified labour in development policy, and a **paradigm shift in the educational system** in accordance with this. The whole of the educational system shall be examined, not only from the point of view of material, professional knowledge, but also with regard to the **spirituality radiating from the system** and playing a determining role in forming social behaviour and vision (this spirituality often conveys a feudal, paternalist ethos, or one reflecting the context of an autocratic political system). Thus, the capability of people to **recognise** and **solve** problems, to **cooperate**, to **undertake a business**, to **risk**, to pay attention to **quality**, and to **receive ever renewing knowledge** shall be strengthened by the way of education. For this it is useful to increase the autonomy of institutions, faculty, and to open the educational system to the international market, furthermore to enhance the free cooperation between universities, research institutions and the business sphere.

The source of the forces compelling and inciting innovation is – though not exclusively – the **market**. We may already call it market building if the government refrains from measures that distort or limit the market, or if it takes efficient action against corruption, which weakens and distorts the market's selection mechanism. The state itself is an important actor of the market through the public procurements. The transparent and ethical operation of this market segment influences favourably the operation of the whole of the market. **Corruption and public procurement are traditionally weak points of Central and Eastern European economies.** In 2012 CEE11 countries were between 32nd and 75th on the list prepared by Transparency International, with the two extreme countries being Estonia and Bulgaria. Through public procurement the state with its orders may incite innovative solutions. **The supporting of innovative enterprises capable of fast growth with market conform measures is an efficient method of "building" the market.** Competition shall be regulated basically by the market, especially in small CEE countries where the majority of the enterprises is not a price maker, cannot influence the prices.

Cohesion funds have an important role in the convergence, in the improving of the competitiveness of CEE11. According to experiences the strongest effect on the rate of convergence between the regions of the EU may be exerted by the development of the **road network** and by investment in **human resources.** Since the breaking out of the economic crisis, with a view to successful crisis management, the EU has made it possible to modify the utilisation purposes of the funds and has reduced the extent

of prescribed own resources. (It would be useful to analyse the results of these measures, including regional comparisons as well.) As previous analyses have already called the attention to the fact that the successfulness and efficiency of cohesion policies is fundamentally influenced by their relation to **other national and European specialised policies,** efficient reaction to the different challenges is only possible through a systemic approach. This raises the possibility of the alternative **where cohesion funds could be used to a greater extent than previously to support reforms in CEE11, as sustainability requires not only individual investments but comprehensive changes in transport, healthcare or education for example.**

Innovation is not identical with R&D based innovation. **In the most developed countries the investment requirement of non-technological innovations may exceed research and development expenditures by orders of magnitude**. In CEE11 public opinion and decision makers are confronted with the fact that **outstanding inventions are wasted or get utilised abroad** because **basic conditions** – primarily possibilities of mass production, business management, marketing and distribution, as well as financing possibilities substantially exceeding the costs of generating inventions – **are not available**. Governments in CEE11 are inclined to interpret innovation very simply, as a **slogan that may be checked out**.

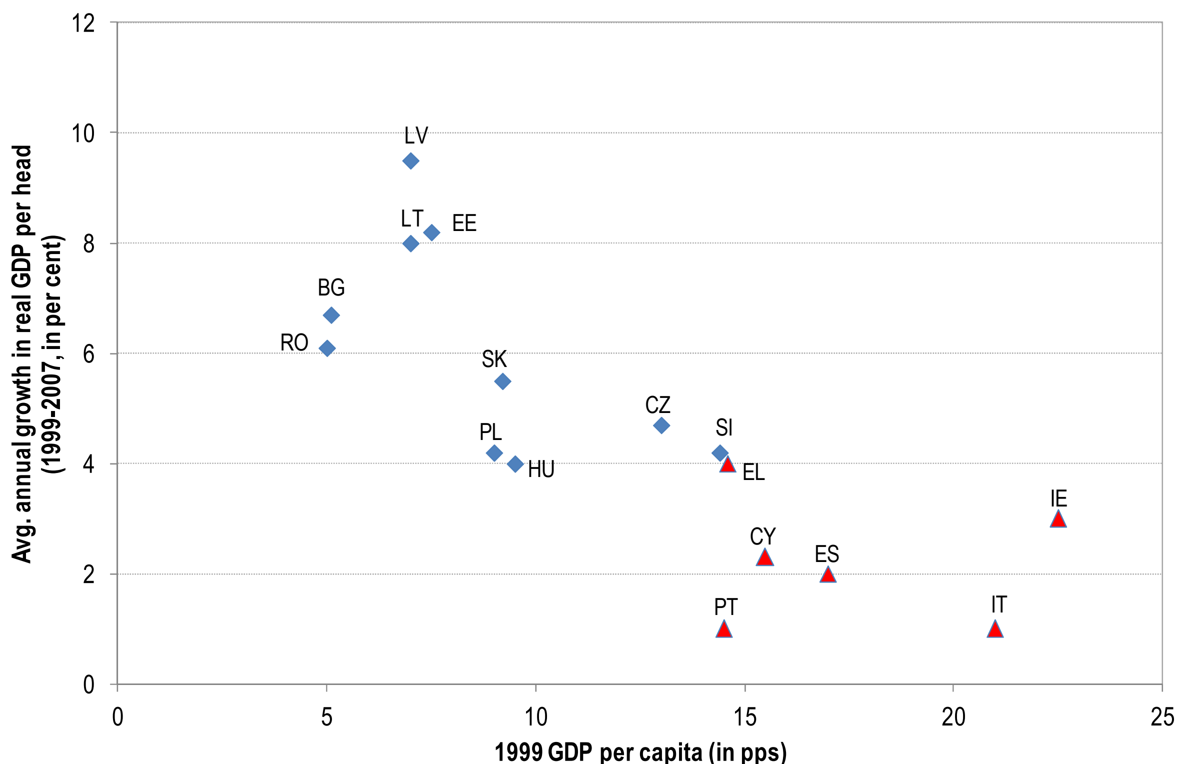
According to data published by the **„Innovation Union**", none of the CEE11 countries play a leading role in the EU in innovation; however **Slovenia** and **Estonia are capable of „stable" results**. The Czech Republic, Slovakia, Hungary and Lithuania (in the company of a couple of Southern European countries) show moderate innovation performance, while the category of weak innovation performer countries in the EU includes exclusively the rest of the CEE11 countries.

An important potential tool for improving competitiveness for the non-EMU member CEE11 countries is the joining of the euro-zone. With the exception of Lithuania, **none of the other** countries **have it on their agenda now**. Whereas several countries – for example Bulgaria or the Czech Republic –, **meet** the majority of **the criteria**, and according to the latest Convergence Programs in a medium term perspective nearly everybody will meet the most problematic budgetary criteria. As euro-zone crisis further consolidates, **the appetite for joining may increase**, especially if the EMU membership can offer further advantages for the newcomers (**for example partially joint debt financing**!).For the time being, CEE countries shall primarily orient their efforts at fulfilling the criteria necessary for introducing the euro, and they shall only set a target date for this, it is also worth learning from the experiences of other member states that are already using the euro. **On the other hand** – learning from experience**- the EMU entry criteria can be simplified, offering an easier accession, whenever the medium term sustainability of the desired processes can be convincing.** (For example the exchange rate movements can be analysed on the factual data, instead of spending 2 years in ERM-2, the budgetary criteria should be no EDP situation for a given period.)

5.4. Forecast

According to the European Commission's forecast in spring 2013, potential growth in the whole of the EU was expected to be 0.5% in 2013 and 0.7% in 2014. As between 2003-2007 this was still 2.1% on the average, it is obvious that **potential and probably actual growth rates in the EU will decrease in the following years**. Naturally, this also exerts a negative effect on the potential growth of CEE11. In 2013, only Estonia, Poland and Slovakia will have a potential growth of around 3%, in 2014 Latvia's as well, while Romania's and Lithuania's will be around 2.5%, with Bulgaria's being around 1.5%. Potential growth in the Czech Republic and Hungary will be under 1% in both years. **When potential growth is below 2%, we may actually speak of convergence only in a mathematical sense.** Moreover, in

Slovenia and Croatia from among the CEE11 countries will have a non-positive potential growth in both years – in the company of three Mediterranean EAP6 countries. This means that **outside the Baltic3 countries only two V5 countries** – Poland and Slovakia – and **one Balkan country** – Romania – has a potential of economic growth that gives some hope for the **actual convergence** to the average of the EU (this latter, however, starts out from a rather low level), while Slovenia, Hungary and Croatia are on a de-converging path.



Source: Quarterly Report on the Euro Area (2013)

The countries of the region depend greatly on **exports** as far as the sources of growth are concerned. A significant part, 60-85%, of their exports is oriented to European markets, and the slow expansion of these is a source of problems. The only exceptions are Poland and Romania, which dispose of a large domestic market. However, the **domestic sources of growth are also weak,** the expenditures of the state and the consumption of households fell back and the consolidation of public finances has decreased the value of state investment (not financed by the EU) to a minimal level. The strategy of economic development building on foreign capital and export orientation has no real alternative. But besides this, inciting competitiveness and job creation in domestic enterprises is also important. **Growth cannot be accelerated without investment.** However, the majority of countries in the Central European region shall first accomplish the **consolidation of public finances**, while sustainable growth still keeps them waiting.

The EAP6 countries based on the GDP per capita (in PPS) of 1999 were far more developed, than the CEE7 and CEE10 countries. However, between 1997 and 2007, in terms of labor productivity and rate of economic growth EAP6 were also behind these countries. Among the CEE7 countries the fastest productivity growth was reached by the poorest Romania, the lowest by Poland and Hungary, which were in a much better position. However, the most developed Czech Republic was capable of a rapid

productivity growth. Baltic3 reached the fastest economic growth, which were followed by the less developed Balkan and the more developed V5 countries.

According to the European Commission's forecast the **GDP** in the whole of the EU will decrease (-0.1%) in 2013, and increase by 1.4% in 2014. From among the CEE11 countries substantially more favourable dynamics is to be expected in the Baltic3, but even growth in Poland, Slovakia, Romania and Bulgaria is more favourable than the average of the EU, while growth in Croatia and Slovenia falls behind this. Hungary will be able more or less to reach the EU average. The situation is even worse in the case of **investments**, where the EU average, 2.6%, forecasted for 2014 will be surpassed substantially – by at least 2 percentage points – only by the Baltic3 and Romania, with Hungary and Slovenia falling behind these. The **investment rate** is low in numerous CEE11 countries. The individual governments hardly have any sources to spend on development besides the EU funds for investment. Moreover, it is a problem for CEE11 countries that after 2015 EU funds will typically **decrease**, while – in a paradox way – in spite of their huge amount, they appear as a narrowing factor of financing. This appreciates the **business environment** and the capital attracting capability of the individual countries even more. Development activity, however, is constrained by the scarcity of credit facilities, and in certain countries by the poor state of the banking sector. The recovery of the economy requires low interest rates in the whole of the global economy. However, under conditions of strict credit policies and strictly controlled repayment abilities not even this will encourage investments, especially if the **profitability of production** is poor due to growing production costs, uncertain market demand, and high taxes. And as far as **household consumption** is concerned, only the Baltic3, Bulgaria and Romania will show more favourable dynamics than the EU average of 1% in 2014, while the figures forecasted for Slovenia, Slovakia and Hungary will at best reach this average. Unemployment and insecurity also determine the trends in household consumption.

As far as **substantial convergence** is concerned, from among the CEE11 countries we may count mainly on the countries that also performed well in the previous decade – the Baltic3, Slovakia and Poland. Growth in the other countries is either too slow. Because of the unfavourable world economic environment, however, **not even** the countries capable of convergence may be **expected to show a rate of growth similarly favourable as in the years after accession**. The relative position of successful countries, however, may be improved by the sliding down of some older (mainly Mediterranean) member states. Nevertheless this sliding down might be experienced in the case of certain V5 countries – first of all in the cases of Hungary and Slovenia as well.

The signs show that **neither good governance** (the Czech Republic), **nor fulfilment of the Maastricht criteria** (Bulgaria), **nor accession to the euro zone** (Slovenia) **is in itself sufficient for success**, not to speak of the case when a country follows an **unorthodox economic policy** (Hungary). The successes of the Baltic3, as having the best chances for convergence, and the partial successes of a number of other countries, seem to imply that convergence has, to a considerable extent, social policy preconditions. Namely, the **forming of social consensus,** that **makes possible to realise long term economic policy and within that reform policy,** reaching over political cycles. Naturally, these processes are not given for once and for all, they may be changed by successful – professionally based and socially acceptable – economic policy. **The countries falling behind today may again converge** if they succeed in **transforming their institutional systems and mechanisms that have been the source of their relative failure**, **just as the more successful ones shall not take it easy either**.

The expected development of CEE countries, 2013-14
(Previous year= 100)

	Potential GDP		GDP		Investment		Household consumption	
	2013	**2014**	**2013**	**2014**	**2013**	**2014**	**2013**	**2014**
Czech Republic	0,6	0,7	-0,4	1,6	-3,2	2,3	-0,4	1,4
Hungary	0,2	0,5	0,2	1,4	-1,5	0,8	0,2	1,0
Poland	2,9	2,7	1,1	2,2	-2,6	2,2	0,8	1,5
Slovenia	-1,0	-0,4	-2,0	-1,0	-4,9	0,1	-3,7	-1,9
Slovakia	2,8	3,2	1,0	2,8	1,4	3,0	0,0	0,9
V5	**1,1**	**1,3**	**0,0**	**1,4**	**-2,2**	**1,7**	**-0,6**	**0,6**
Bulgaria	1,1	1,5	0,9	1,7	3,0	3,1	1,4	2,5
Croatia	-0,8	0,0	-1,0	0,2	-0,5	4,0	-2,0	-0,5
Romania	2,1	2,6	1,6	2,2	3,4	5,0	1,9	2,0
Balkan3	**0,8**	**1,4**	**0,5**	**1,4**	**2,0**	**4,0**	**0,4**	**1,3**
Estonia	3,2	3,9	3,0	4,0	3,0	7,3	3,3	3,5
Latvia	2,0	3,0	3,8	4,1	6,9	8,1	3,9	4,1
Lithuania	2,4	2,5	3,1	3,6	4,8	6,7	2,9	3,8
Baltic3	**2,5**	**3,1**	**3,3**	**3,9**	**4,9**	**7,4**	**3,4**	**3,8**
CEE11	**1,4**	**1,8**	**1,0**	**2,1**	**0,9**	**3,9**	**0,8**	**1,7**
EU	**0.5**	**0.7**	**-0.1**	**1.4**	**-1.7**	**2.6**	**-0.4**	**1.0**

Note: The figures of the individual country groups (except the EU) are un-weighted averages
Source: European Commission

6. Lessons, conclusions, recommendations

6.1. Lessons and conclusions

6.1.1 Convergence

The majority of the examined CEE11 countries joined the EU almost a decade ago and the convergence process was successful till the crisis: the average CEE11 country GDP per capita improvement was 8.4 percentage points (compared to EU average) between 2003 and 2007. **The financial and economic crisis caused a really grave setback in the process.** Between 2007 and 2012 these countries recorded **some further convergence, but only a marginal one.** (In the same time, **with the exception of Ireland, the EAP6 divergence took place**.) There were great differences even within the CEE11 (Poland: +11, Slovenia: -7). **Only Poland, Lithuania, Bulgaria, Romania and Slovakia were able to reach a further sizable catching up.** Slovenia and the Czech Republic jagged behind considerably. Despite the rather diverse developments within the CEE11, the **ranking** of the countries' development level by GDP per capita **hardly changed; only Poland stepped forward from the 9th to the 6th place**. For the time being Slovenia kept its leading place, though it fell back. Slovenia, the Czech Republic and Slovakia reached the development level of the least developed "old" EU member state namely Portugal and Greece (as they dropped).

GDP (PPS) per capita by countries as a per cent of the EU average
(In %, deviation in percentage points)

	2003	2007	2012	2007-2003 deviation	2012-2007 deviation	2012-2003 deviation
Estonia	55	70	69	15	-1	**14**
Latvia	44	58	63	14	5	**19**
Lithuania	50	62	70	12	8	**20**
Czech Rep	77	83	79	6	-4	**2**
Hungary	63	62	66	-1	4	**3**
Poland	49	55	66	6	11	**17**
Slovenia	84	89	82	5	-7	**-2**
Slovakia	56	68	75	12	7	**19**
Bulgaria	34	40	47	6	7	**13**
Croatia	55	61	61	6	0	**6**
Romania	31	42	49	11	7	**18**

Analysing the decade as a whole, **the most developed three countries at the accession** (Slovenia, Czech Republic and Hungary) **nearly could not catch up at all!**

6.1.2. Competitiveness

In the major international competitiveness rankings (IMD, WEF) both the CEE11 and the EAP6 countries rank almost 10 places behind their previous ranking on the average. The Baltic3 moved back less, the V5 and the Balkan3 more than that. Poland did not lose ground, however Slovenia fell substantially (while within the EAP6 it was Greece, Cyprus and Spain, whose competitiveness deteriorated the most).

6.1.3. Human Development

As far as the UN Human Development Index is concerned; **the CEE11 countries advanced 3 places on the average** (whereas the number of countries surveyed increased from 167 to 194). Estonia, the Czech Republic, Slovakia and Romania recorded improvement, and not a single country fell back considerably. In contrast to this, the EAP6 countries' positions deteriorated by 5 places on the average, mainly those of Greece, Portugal, Spain and Italy. Measured by this indicator as well, Slovenia, the Czech Republic, Estonia and Slovakia overtook, or reached Portugal and Greece.

6.1.4. Crisis hit

In the course of the crisis the CEE11 was hit mostly by the freeze of the international capital movements (banking, bond markets, FDI) and **by the drop of the import needs** of other EU (and non-EU) countries. The **CEE11 countries faced macroeconomic imbalances, current account balance and foreign debt financing problems and at some cases even crisis, rather than a general government debt crisis** (the debt ratio level remained modest). They achieved **fast and radical improvement: their foreign trade and current account balance improved on the average by 5 per cent of their GDP, why the current plus capital account improved even by higher size (thanks to EU funds growing inflow)**. They accomplished better export growth rates than the EU and the growth rate of their investment and consumption was close to EU average. (They outperformed the EAP6 significantly). Their general government deficit grew, although by far less than the EU average. But as their general government debt to GDP rate in 2008 was around half of the EU average, the banking consolidation expenditures were minimal and the fiscal austerity went ahead, **they could slow down the growth of the general government debt.** Employment decreased more considerably than the EU average, however, due to migration, **unemployment increased in line with the EU average**. Central and Eastern European (mainly Polish, Romanian, Baltic and Hungarian) labour force proved to be extremely flexible.

The general government deficit is already below or just around 3% of the GDP in the majority of the countries, and the general government **debt increase is a potentially EDP creating problem only in Slovenia and Croatia.** In order to prevent this and to open room for additional budgetary spending Poland is just reversing its pension reform, and **actually raising its implicit general government debt.** (Here it can be seen **what damages it caused that in the '90s the EU handled the pension reforms in a rather inflexible way,** not really giving regulatory room for bearing the fiscal burdens of these transformations, in spite of their positive fiscal effects in the long term.)

6.1.5. Growth performance

Until now in the management of the crisis **the growth performance of 3 countries:** Poland, Estonia and Slovakia **were the best**. One is large, one small and one medium sized country. One is Baltic3 and two V5 countries. As far as their **GDP (PPS) per capita is concerned, none of them was among the top three countries (Slovenia, the Czech Republic, Hungary) in 2004, at the time of EU accession.**

In the management of the crisis measured by growth **the worst performing 3 countries** were **Slovenia, Croatia and Hungary**. Their p**otential growth rate is negative or around zero.** One Balkan (though only recently joined) and two V5 countries; two of them joined the EU with rather high expectations; in 2004 one of them even joined the EMU.

It was neither size, nor geographical location, nor EMU membership, nor the development level that mattered. Actually a lot of social, political and economic factors influence the outcome. Most probably in addition to inherited strengths and weaknesses a **decisive role** was played by the **performance of the national governance**, based on the good **understanding of the changes in the world** and of the **deepness of the crisis**. Successful countries **prepared themselves for unexpected events, collected and mobilised reserves, looked for international political and economic support** and supporters. They took advantage of the available room of manoeuvring and, most of all; they **improved their ability to adapt**.

It is widely supposed that an important role in rather favourable adaptations in the region was played by **relying on floating exchange rate policies**. This is a **rather strong exaggeration**. As 3 countries have joined the euro-zone and further 4 countries utilised a currency board agreement (CBA), which essentially fixed the exchange rate, only 4 countries had a floating exchange rate regime. Within these only Romania experienced **lasting and substantial,** whereas Poland and Hungary moderate depreciations. From among the latter countries, **Poland proved to be the most successful crisis managing one**, whereas **Hungary turned out to be one of the least successful ones.** The possibility of an independent exchange rate policy is **not necessarily decisive**.

6.1.6. Investments

From among the economic factors it is investment that proved to be the most important. From this point of view, Poland, with a **large domestic market** started with a great advantage, that it actually made use of. Where a country could succeed in achieving an only temporary setback in investment, there **the number of persons employed in the business sector started to rise after a serious decrease, and all this had a favourable effect on both consumption and budget revenues**. As money markets react extremely fast to changes in external debt or general government debt ratio, economic growth has a special role, and the creation of a **growth-friendly economic climate** could prove to be decisive.

6.1.7. Fiscal adjustment

Countries that **postponed fiscal adjustment** or only adjusted through **austerity without structural changes** got into a difficult situation. However, countries that took bold **steps that were seriously destructive to social security** in order to improve fiscal balances rapidly also got in a difficult situation. **The extremely flexible labour market of the Baltic countries endured the extreme burden of internal devaluation.** But this was the result of special factors and is unrepeatable elsewhere. **Frontloaded steps lacking the necessary gradualist cautiousness** did not lead to lasting results for example in Bulgaria. Unusual economic policy tools were applied in practically all countries – owing to the extreme situation. Nevertheless, the attempt to shift the burden of the crisis upon the business sector by the **excessive broadening of the role of the state** (by income redistribution, by the forceful restructuring of markets) and by the **extreme size of special taxes levied on** certain economic sectors, **also proved to be un-successful**. As this affected primarily the **banking and the energy sectors,** as well as other **sectors of the economy that play an important role in modernisation**, and as it led to the substantial decrease of profit rates of the affected large companies, it also resulted in the significant decrease of investments, as well as the reduction of the lending capacity of the financial sector. Thus, on the contracting domestic market SMEs got into an even worse situation. Because of the deterioration of the position of the general government, newer and newer phases of **austerity** were (and are) necessary (such as in Hungary).

International experience shows that fiscal adjustment has the most favourable effects if:

- the **adjustment** is well planned in its timing (is neither too fast, nor too slow);
- it is concerned with the **stake-holders**, and **involves lasting structural changes**;
- **the banking system is solid** with a **good lending capacity,** and is oriented to lending (in order for it to be able to convey timely and efficiently the assets arising from fiscal adjustment to market actors);
- **social welfare services are strong**, so that they could defend the needy who had been most affected by the adjustment, and maintain social peace.

6.2. Recommendations

On the basis of all of the above, we here phrase the following **concrete recommendations**:

6.2.1. Supporting sound budgetary policies, smart budget reforms

1. **The EU programs** in the 2014-2020 periods should **support the public service reforms**, aiming to reach long term savings on budgetary spending and to improve the quality of public services as well. The reforms in many cases needs initial extra spending, which can be covered by the EU programs.

2. Budget consolidation would be easier if **debt financing could be made cheaper**. This would also make it possible to **support responsible national budgetary policy not only with sanctions, but with positive incentives as well.**

   One of the long term goals of establishing a fiscal union should be the **common financing of general government debt**. The new EDP regulations indirectly set the target that within 20 years the government debt of all EU member states should decrease below 60% of the GDP. In accordance with this, **an institutional reform gradually, over twenty years, establishing a common pool for the financing of state debt could be implemented**.

6

   An EU level Treasury should be established, which would issue bonds in its own name, and would use the funds gradually to act as a purchaser of newly issued government securities of EU member states meeting certain requirements (if they offer these for sale to it). This possibility would be available for all countries with a general government debt rate to GDP below 60%, or where the rate is higher than 60%, but the country meets the new debt reduction regulation. In this case the new EU Treasury would participate as a purchaser of government securities in the financing of the given country yearly up to maximum 3% of GDP. (It is also a possibility that for countries under EDP this option would be suspended even at less than 60% to GDP debt rate, whereas for countries with an extremely high rate of debt – e.g. over 100% to GDP – this option would not be available.) The yield demanded by the EU Treasury after the government securities of the given country could be somewhere between the market yield prevailing in the given country and the actual funding cost. This would imply a saving for the budget of the given country, while also giving a possibility for the formation of provisions at the EU Treasury.

   It would be worthwhile considering the possibility for the **ECB as well to purchase government securities of non-euro zone member states, if the given country is not under EDP**. In certain cases this could be an important stabilising and cost reducing factor in debt financing.

   Through their cheaper and more stable financing possibilities, both solutions could constitute **positive incentives** to maintain fiscal discipline.

3. **Coordinated measures at the level of** EU and member states **against tax evasion and fraud** may support national budgetary consolidation (and even increase the revenues of the EU budget as well.) The harmonisation of different tax and social security regulations might narrow the scope for legally fair tax avoidance.

4. Modest **inflation - under well designed circumstances- might help to improve the budget equilibrium (and to diminish the government debt rate),** if it does not impede competitiveness. Even in euro-zone member states, price raises in the **non-tradable sector, especially allowing the reduction of budget subsidies, and enforce the bearing of real costs may help budgetary consolidation.** For non-euro zone member states which do not have a fixed exchange rate regime, **inflation targeting monetary policy should not be treated as a must**, or the inflation target may be higher than that prescribed by the Maastricht criterion.

5. **It would be worthwhile promoting and supporting the joint management of certain government functions** (foreign representation, higher education, selected special hospital treatments, etc.) **with the cooperation of several member states.**

6. It would be worthwhile establishing an EU think tank, **an independent institution within the apparatus of the European Commission, which would deal with the experiences of budgetary reforms, best practices and lessons drawn from mistakes, and which would also grant professional assistance or "technical assistance" upon request to the member states.** (The OECD, the IMF and the World Bank partly fulfil such a function, but they do not focus primarily on EU member states, and the EU member countries do not conduct their regular dialogues on policy matters primarily with these organisations.) Governments and the EU could both benefit from this, experience and cooperation could be built in more organically into the process of annual economic policy consultations.

7. **The EP and all EP party fractions should offer political support for the elaboration and the implementation of the national reform programs.** The communication of the experience of other countries, including the best practices might help to convince the stakeholders of the national reforms as well.

6.2.2. Supporting the decrease of the general government debt

1. It is worthwhile giving **incentives to privatisation where it involves the reduction of debt and the increase of competition**. In sectors that are sensitive to these (e.g. utilities) the renewal of EU regulations related to the economic and legal environment may help governments to avoid anomalies often following privatisation, and not to refrain from their positive decisions on privatisation.

2. The **new EDP rules concerning the general government debt** should be fine tuned. The required yearly improvement above 60% indebtedness (5% of the difference between the base year's data and the 60 % each year)should be always calculated compared to a stable initial year (for example 2015), instead of a constantly moving last year base (never reaching the below 60 % target).

3. **The macro assumptions** (long term growth, inflation and interest rate forecasts) should be discussed and revised before the elaboration of the next EC Fiscal Sustainability Report.

6.2.3. Growth is the main remedy against indebtedness

1. **The economic policies of the EU, using the new tools of the economic governance should aim to improve the growth potential of the EU, such character should be** strengthened**.**

2. Direct incentives for economic growth should only be moderate and targeted, but among others **it would be worthwhile strengthening non-bank financing channels accessible for the SME sector. Market instruments can be considered** (for example: cheap refinancing and/or capital increase for leasing companies, risk capital funds, SME oriented other special intermediaries, guarantee institutions.) National or international (focusing for Baltic3, or Balkan, etc.) arrangements should be created and **financed in the framework of the EU programs, from EIB lending and possibly even from EU budget and national budgets or national development banks as well.** As a condition for EU participation the business model and the main business conditions should be regulated and accepted by EU.

3. **National and EU level deregulation programmes could decrease the burdens of enterprises, as well as the level of costs in public administration.**

4. As **higher education is a main driving force for growth in a longer run,** special university funds should be allocated in the EU budget to help universities to attract the best experts of the word. At the 200 best universities in the EU, quotas should be established for students coming from the less developed EU member states, and meeting the requirements. These 200 universities should receive extra funds from the EU budget.

5. **For the non euro-zone CEE11 countries the joining of the EMU will have a positive effect on growth and competitiveness.** As euro zone crisis further consolidates, the appetite for joining may increase, especially if the EMU membership can offer further advantages for the newcomers (for example partially joint debt financing). For the time being, CEE countries shall primarily orient their efforts at fulfilling the criteria necessary for introducing the euro, and they shall only set a target date for this, it is also worth learning from the experiences of other member states which are already using the euro. On the other hand –learning from experience**- the EMU entry criteria can be simplified, offering an easier accession, whenever the medium term sustainability of the desired budgetary and economic policy processes are convincing.** (For example the exchange rate movements can be analyzed on the factual data, instead of spending two years in ERM-2, the budgetary criteria might be no EDP for a given period, instead of special process.)

6.2.4. Towards Social Union

1. A **social welfare oriented EU**, managing functions that are visible and may be perceived by the citizens, is necessary. In the context of the **correction of the EU,** the place of **the social union** should also be set on the road map, in addition to the fiscal, the banking, the economic and the political union. The existing macroeconomic surveillance should be reinforced by a strengthened surveillance of employment and social policies. The policy coordination and the introduction of some new EU standards should prevent the national social policies from becoming a main adjustment tool in fiscal consolidation and in regaining competitiveness.

2. The **basic principles of pension systems and unemployment benefits** should be unified, also making use of their role in shaping the business cycles.

3. The basic elements of a mandatory funded state pension sub-system **should be elaborated complementing the system of social security.** The funded sub-system should be treated as a part of the General Government during EDP process.

4. **Solidarity funds impeding social backwardness** should be established by increasing the EU budget. They should involve sufficient funds aimed at investments in human capital, among others to alleviate **child poverty,** to solve the problem of **homelessness**, and **Roma inclusion**.

5. The EU should set to ensure the transferability of social rights of individuals among member countries.

6. Measures are needed to improve the mobility of workers in EU, among others by removing the existing legal and regulation barriers.

STATISTICAL ANNEX

Gross external debt position

(End of year, as a percentage of GDP)

	2007	2008	2009	2010	2011	2012
Estonia	114.5	112.6	130.9	117.0	90.5	100.0
Latvia	135.4	124.6	161.4	164.2	133.7	140.1
Lithuania	77.0	68.5	87.0	83.8	72.3	77.7
Baltic3	**108.9**	**101.9**	**126.4**	**121.7**	**98.9**	**105.9**
Czech Republic	42.1	36.9	45.2	48.1	43.6	52.1
Hungary	130.0	144.5	189.5	160.8	150.5	161.2
Poland	54.9	46.4	65.1	67.5	62.2	74.5
Slovenia	108.2	100.0	118.1	116.0	103.6	118.5
Slovakia	52.7	53.6	75.6	76.2	71.4	74.7
V5	**77.6**	**76.3**	**98.7**	**93.7**	**86.3**	**96.2**
Bulgaria	101.4	99.6	114.0	105.7	88.4	99.0
Croatia	83.6	81.2	105.6	106.3	96.4	106.0
Romania	-	49.0	72.2	76.1	68.1	78.0
Balkan3	**92.5**	**76.6**	**97.3**	**96.0**	**84.3**	**94.3**
CEE11	**81.8**	**83.4**	**105.9**	**102.0**	**89.2**	**98.3**

Source: World Bank

Gross debt, general government

(ESA, as a percentage of GDP)

	1995	2003-2007	2008	2009	2010	2011	2012	2013	2014
Estonia	8.2	4.7	4.5	7.2	6.7	6.2	10.1	10.2	9.6
Latvia	15.1	12.4	19.8	36.9	44.4	41.9	40.7	43.2	40.1
Lithuania	11.5	18.7	15.5	29.3	37.9	38.5	40.7	40.1	39.4
Baltic3	**11.6**	**11.9**	**13.3**	**24.5**	**29.7**	**28.9**	**30.5**	**31.2**	**29.7**
Czech Republic	14.0	28.4	28.7	34.2	37.8	40.8	45.8	48.3	50.1
Hungary	85.6	62.6	73.0	79.8	81.8	81.4	79.2	79.7	78.9
Poland	49.0	46.5	47.1	50.9	54.8	56.2	55.6	57.5	58.9
Slovenia	18.6	26.2	22.0	35.0	38.6	46.9	54.1	61.0	66.5
Slovakia	22.1	35.6	27.9	35.6	41.0	43.3	52.1	54.6	56.7
V5	**37.9**	**39.9**	**39.7**	**47.1**	**50.8**	**53.7**	**57.4**	**60.2**	**62.2**
Bulgaria	-	29.5	13.7	14.6	16.2	16.3	18.5	17.9	20.3
Croatia	-	35.7	28.8	35.7	42.2	46.7	53.7	57.9	62.5
Romania	6.6	16.2	13.4	23.6	30.5	34.7	37.8	38.6	38.5
Balkan3	**-**	**27.1**	**18.6**	**24.6**	**29.6**	**32.6**	**36.7**	**38.1**	**40.4**
CEE11	**25.6**	**28.8**	**26.8**	**34.8**	**39.3**	**41.2**	**44.4**	**46.3**	**47.4**

Source: EU 2013 Spring Forecast

Net lending(+) or net borrowing(-) general government

(ESA, as a percentage of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014
Estonia	2.4	-2.9	-2.0	0.2	1.2	-0.3	-0.3	0.2
Latvia	-0.4	-4.2	-9.8	-8.1	-3.6	-1.2	-1.2	-0.9
Lithuania	-1.0	-3.3	-9.4	-7.2	-5.5	-3.2	-2.9	-2.4
Baltic3	**0.3**	**-3.5**	**-7.1**	**-5.0**	**-2.6**	**-1.6**	**-1.5**	**-1.0**
Czech Republic	-0.7	-2.2	-5.8	-4.8	-3.3	-4.4	-2.9	-3.0
Hungary	-5.1	-3.7	-4.6	-4.3	4.3	-1.9	-3.0	-3.3
Poland	-1.9	-3.7	-7.4	-7.9	-5.0	-3.9	-3.9	-4.1
Slovenia	0.0	-1.9	-6.2	-5.9	-6.4	-4.0	-5.3	-4.9
Slovakia	-1.8	-2.1	-8.0	-7.7	-5.1	-4.3	-3.0	-3.1
V5	**-1.9**	**-2.7**	**-6.4**	**-6.1**	**-3.1**	**-3.7**	**-3.6**	**-3.7**
Bulgaria	1.2	1.7	-4.3	-3.1	-2.0	-0.8	-1.3	-1.3
Croatia	-2.0	-2.0	-4.7	-5.2	-5.7	-3.8	-4.7	-5.6
Romania	-2.9	-5.7	-9.0	-6.8	-5.6	-2.9	-2.6	-2.4
Balkan3	**-1.7**	**-2.0**	**-6.0**	**-5.0**	**-4.4**	**-2.5**	**-2.9**	**-3.1**
CEE11	**-1.1**	**-2.7**	**-6.5**	**-5.5**	**-3.3**	**-2.8**	**-2.8**	**-2.8**

Source: EU 2013 Spring Forecast

Structural budget balance, general government

(ESA, as a percentage of GDP)

	2003-2007	2008	2009	2010	2011	2012	2013	2014
Estonia	-0.2	-4.5	-1.1	-1.1	-0.6	0.2	-0.2	0.2
Latvia	-2.6	-5.6	-5.5	-2.9	-1.6	-0.3	-1.4	-1.5
Lithuania	-2.5	-5.3	-6.6	-4.7	-4.9	-3.2	-2.8	-2.8
Baltic3	**-1.8**	**-5.1**	**-4.4**	**-2.9**	**-2.4**	**-1.1**	**-1.5**	**-1.4**
Czech Republic	-3.9	-4.3	-5.4	-4.5	-3.0	-1.7	-1.6	-2.1
Hungary	-8.7	-4.6	-2.3	-3.3	-4.1	-0.7	-1.1	-1.8
Poland	-4.1	-5.0	-8.2	-8.3	-5.4	-3.6	-3.3	-2.9
Slovenia	-2.6	-4.4	-4.4	-4.7	-4.7	-2.7	-2.4	-3.3
Slovakia	-2.9	-4.1	-7.2	-7.1	-5.2	-4.1	-3.0	-2.4
V5	**-4.4**	**-4.5**	**-5.5**	**-5.6**	**-4.5**	**-2.5**	**-2.3**	**-2.5**
Bulgaria	0.1	-0.2	-3.5	-2.1	-1.6	-0.4	-0.8	-0.9
Croatia	-	-	-	-	-	-	-	-
Romania	-3.0	-7.9	-9.5	-6.2	-4.0	-2.7	-1.7	-1.4
Balkan2	**-1.5**	**-4.0**	**-6.5**	**-4.1**	**-2.8**	**-1.5**	**-1.2**	**-1.1**
CEE10	**-3.0**	**-4.6**	**-5.4**	**-4.5**	**-3.5**	**-1.9**	**-1.8**	**-1.9**

Source: EU 2013 Spring Forecast

Interest expenditure, general government

(ESA, as a percentage of GDP)

	2003-2007	2008	2009	2010	2011	2012	2013	2014
Estonia	0.2	0.2	0.2	0.1	0.1	0.2	0.2	0.2
Latvia	0.6	0.6	1.5	1.4	1.5	1.3	1.5	1.6
Lithuania	0.9	0.7	1.3	1.8	1.8	1.8	1.8	1.8
Baltic3	**0.6**	**0.5**	**1.0**	**1.1**	**1.1**	**1.1**	**1.2**	**1.2**
Czech Republic	1.1	1.1	1.3	1.4	1.4	1.5	1.6	1.6
Hungary	4.2	4.2	4.7	4.1	4.1	4.2	4.2	4.0
Poland	2.7	2.2	2.6	2.7	2.7	2.8	2.7	2.5
Slovenia	1.6	1.1	1.3	1.6	1.9	2.1	2.3	2.8
Slovakia	1.9	1.2	1.4	1.3	1.6	1.9	1.9	1.9
V5	**2.3**	**2.0**	**2.3**	**2.2**	**2.3**	**2.5**	**2.5**	**2.6**
Bulgaria	1.7	0.9	0.8	0.7	0.7	0.9	0.9	0.9
Croatia	-	1.5	1.7	2.0	2.2	2.7	3.2	3.5
Romania	1.2	0.7	1.5	1.5	1.6	1.8	1.8	1.8
Balkan3	**1.5**	**1.0**	**1.3**	**1.4**	**1.5**	**1.8**	**2.0**	**2.1**
CEE11	**1.6**	**1.3**	**1.7**	**1.7**	**1.8**	**1.9**	**2.0**	**2.1**

Source: EU 2013 Spring Forecast

GDP index at current prices

(Compared to preceding year)

	2009	2010	2011	2012	2013	2014
Estonia	84.8	104.1	111.4	106.6	106.9	106.1
Latvia	81.3	97.8	111.7	108.7	106	106.4
Lithuania	82.2	103.6	111.6	106.4	105.6	106.7
Baltic3	**82.8**	**101.8**	**111.6**	**107.2**	**106.2**	**106.4**
Czech Republic	97.7	101.1	101.1	99.9	102.1	103
Hungary	96.5	103.8	104.8	102.4	102.4	104
Poland	105.4	105.4	107.5	104.3	102.5	104.5
Slovenia	95.5	100.1	101.6	98	99	102.7
Slovakia	93.9	104.9	104.9	103.4	103.7	104.3
V5	**97.8**	**103.1**	**104.0**	**101.6**	**101.9**	**103.7**
Bulgaria	98.6	103.2	106.8	103	103.3	104.3
Croatia	95.7	98.5	102	100	101.9	104.4
Romania	97.4	104.5	106.3	105.5	106.5	105.7
Balkan3	**97.2**	**102.1**	**105.0**	**102.8**	**103.9**	**104.8**
CEE11	**93.5**	**102.5**	**106.3**	**103.5**	**103.6**	**104.7**

Source: IMF

Current account balance
(As a percentage of GDP)

	2003-2007	2008	2009	2010	2011	2012	2013	2014
Estonia	-12.9	-8.5	4.2	3.2	0.6	-3.1	-2.2	-2.0
Latvia	-15.7	-13.1	8.6	2.9	-2.4	-1.7	-2.1	-2.6
Lithuania	-9.3	-13.0	2.1	-0.4	-3.7	-0.5	-1.0	-1.5
Baltic3	**-12.6**	**-11.5**	**5.0**	**1.9**	**-1.8**	**-1.8**	**-1.8**	**-2.0**
Czech Republic	-3.8	-2.9	-3.3	-5.2	-3.9	-2.6	-2.4	-2.5
Hungary	-8.2	-6.9	-0.1	1.2	1.0	1.9	2.5	2.6
Poland	-3.3	-5.6	-3.1	-4.3	-4.5	-3.3	-2.5	-2.4
Slovenia	-2.4	-6.1	-0.4	-0.4	0.1	2.7	4.8	4.7
Slovakia	-7.1	-6.3	-2.5	-2.5	-2.5	2.0	2.5	3.3
V5	**-5.0**	**-5.6**	**-1.9**	**-2.2**	**-2.0**	**0.1**	**1.0**	**1.1**
Bulgaria	-13.3	-23.2	-9.0	-0.4	0.1	-1.1	-2.6	-3.6
Croatia	-5.9	-8.3	-4.5	-1.5	-0.9	-0.1	0.4	0.0
Romania	-8.8	-11.4	-4.2	-4.4	-4.5	-4.0	-3.9	-3.8
Balkan3	**-9.3**	**-14.3**	**-5.9**	**-2.1**	**-1.8**	**-1.7**	**-2.0**	**-2.5**
CEE11	**-8.2**	**-9.6**	**-1.1**	**-1.1**	**-1.9**	**-0.9**	**-0.6**	**-0.7**

Source: EU 2013 Spring Forecast

Ratio of national currency debt to gross consolidated government debt
(Percentage points, for non euro zone countries)

	2007	2008	2009	2010	2011	2012
Estonia	11.4	-	3.8	11.0	-	-
Latvia	40.2	41.4	20.3	18.1	16.3	14.4
Lithuania	16.8	15.8	8.5	12.2	13.5	16.9
Baltic3	**22.8**	**28.6**	**10.9**	**13.8**	**14.9**	**15.7**
Czech Republic	90.4	86.2	83.7	82.1	83.6	81.4
Hungary	68.3	59.8	53.5	53.0	48.2	56.5
Poland	-	-	-	73.0	69.1	69.6
V3	**79.4**	**73.0**	**68.6**	**69.4**	**67.0**	**69.2**
Bulgaria	23.1	24.4	23.4	25.7	26.3	22.4
Romania	33.8	40.0	39.1	39.6	40.7	44.0
Balkan2	**28.5**	**32.2**	**31.3**	**32.7**	**33.5**	**33.2**
CEE8	**40.6**	**44.6**	**33.2**	**39.3**	**42.5**	**43.6**

Source: GKI calculations from Eurostat data

The foreign financing ratio of the consolidated gross government debt

(Percentage points)

	2007	2008	2009	2010	2011	2012
Estonia	41.3	36.7	46.2	37.5	39.5	64.0
Latvia	59.5	43.3	69.5	79.9	79.4	81.0
Lithuania	67.2	64.2	70.1	73.2	73.6	75.3
Baltic3	**56.0**	**48.1**	**61.9**	**63.5**	**64.2**	**73.4**
Czech Republic	23.8	26.2	27.5	34.3	34.7	26.7
Hungary	49.1	51.6	55.7	56.8	65.2	61.9
Poland	37.2	34.1	37.5	42.9	48.1	51.6
Slovakia	39.2	39.1	35.2	37.0	40.1	47.4
V4	**37.3**	**37.8**	**39.0**	**42.8**	**47.0**	**46.9**
Bulgaria	30.2	31.5	29.2	32.0	31.4	29.4
Romania	58.9	53.0	55.3	50.5	44.4	47.2
Balkan2	**44.6**	**42.3**	**42.3**	**41.3**	**37.9**	**38.3**
CEE9	**45.2**	**42.2**	**47.4**	**49.3**	**50.7**	**53.8**

Source: Eurostat

General government total expenditure

(ESA, as a percentage of GDP)

	2007	2008	2009	2010	2011	2012
Estonia	34.0	39.7	45.5	40.7	38.3	40.5
Latvia	36.0	39.1	43.7	43.4	38.4	36.5
Lithuania	34.6	37.2	44.9	42.4	38.9	36.1
Baltic3	**34.9**	**38.7**	**44.7**	**42.2**	**38.5**	**37.7**
Czech Republic	41.0	41.1	44.7	43.8	43.2	44.6
Hungary	50.7	49.2	51.4	49.8	49.6	48.6
Poland	42.2	43.2	44.6	45.4	43.4	42.3
Slovenia	42.4	44.3	49.3	50.4	50.8	49.0
Slovakia	34.2	34.9	41.6	40.0	38.3	37.4
V5	**42.1**	**42.5**	**46.3**	**45.9**	**45.1**	**44.4**
Bulgaria	39.2	38.4	41.4	37.4	35.6	35.7
Romania	38.2	39.3	41.1	40.1	39.4	36.4
Balkan2	**38.7**	**38.9**	**41.3**	**38.8**	**37.5**	**36.1**
CEE10	**39.3**	**40.6**	**44.8**	**43.3**	**41.6**	**40.7**

Source: European Commission DG ECFIN

General government total revenue

(ESA, as a percentage of GDP)

	2007	2008	2009	2010	2011	2012
Estonia	36.4	36.7	43.5	40.9	39.5	40.2
Latvia	35.6	34.9	34.0	35.3	34.9	35.2
Lithuania	33.6	34.0	35.5	35.2	33.3	32.8
Baltic3	**19.4**	**21.6**	**18.9**	**27.9**	**12.1**	**19.5**
Czech Republic	40.3	38.9	38.9	39.1	40.0	40.3
Hungary	45.6	45.5	46.9	45.4	53.8	46.6
Poland	40.3	39.5	37.2	37.6	38.4	38.4
Slovenia	42.4	42.4	43.1	44.5	44.4	45.0
Slovakia	32.4	32.8	33.5	32.3	33.3	33.1
V5	**40.2**	**39.8**	**39.9**	**39.8**	**42.0**	**40.7**
Bulgaria	40.4	40.1	37.1	34.3	33.6	34.9
Romania	35.3	33.6	32.1	33.3	33.8	33.5
Balkan2	**37.9**	**36.9**	**34.6**	**33.8**	**33.7**	**34.2**
CEE10	**38.2**	**37.8**	**38.2**	**37.8**	**38.5**	**38.0**

Source: European Commission DG ECFIN

Capital plus current account

(In percentage of GDP)

	2007	2008	2009	2010	2011	2012
Estonia	-14.9	-7.8	6.9	6.5	6.3	2.0
Latvia	-20.4	-11.7	11.1	4.9	0.0	1.3
Lithuania	-12.7	-11.1	7.1	2.7	-1.3	1.7
Baltic3	**-16.0**	**-10.2**	**8.4**	**4.7**	**1.7**	**1.7**
Czech Republic	-3.7	-1.4	-1.0	-3.0	-2.3	-1.1
Hungary	-6.6	-6.3	0.9	2.9	3.1	4.4
Poland	-5.1	-5.4	-2.2	-3.3	-2.9	-1.3
Slovenia	-4.9	-6.2	-0.7	-0.4	-0.3	2.2
Slovakia	-4.7	-4.9	-1.9	-2.2	-0.8	4.2
V5	**-5.0**	**-4.8**	**-1.0**	**-1.2**	**-0.6**	**1.7**
Bulgaria	-27.1	-22.3	-7.6	-0.7	1.4	0.0
Croatia	-7.1	-8.7	-4.8	-0.8	-0.8	0.0
Romania	-12.8	-11.1	-3.6	-4.2	-3.9	-2.6
Balkan3	**-15.7**	**-14.0**	**-5.3**	**-1.9**	**-1.1**	**-0.9**
CEE11	**-10.9**	**-8.8**	**0.4**	**0.2**	**-0.1**	**1.0**

Source: European Commission DG ECFIN

NET FDI

(In percentage of GDP)

	2007	2008	2009	2010	2011	2012
Estonia	4.4	2.6	1.5	7.7	7.8	2.6
Latvia	6.8	3.1	0.6	1.5	4.9	2.8
Lithuania	3.6	3.5	-0.5	2.2	3.3	2.2
Baltic3	**4.9**	**3.1**	**0.5**	**3.8**	**5.3**	**2.5**
Czech Republic	4.9	1.0	1.0	2.5	1.2	4.7
Hungary	0.2	2.6	0.2	0.8	0.8	2.3
Poland	4.3	2.0	1.9	1.4	2.3	0.9
Slovenia	-0.6	0.9	-1.8	0.3	1.8	0.5
Slovakia	4.5	4.6	-1.1	1.1	1.7	3.1
V5	**2.7**	**2.2**	**0.0**	**1.2**	**1.6**	**2.3**
Bulgaria	28.7	17.5	7.1	2.7	3.1	3.3
Croatia	8.0	6.9	3.3	1.0	2.4	2.4
Romania	5.6	6.7	3.0	1.8	1.3	3.1
Balkan3	**14.1**	**10.4**	**4.5**	**1.8**	**2.3**	**2.9**
CEE11	**6.4**	**4.7**	**1.4**	**2.1**	**2.8**	**2.5**

Source: Eurostat

GDP growth

(In percentage to preceding year)

	2003-2007	2008	2009	2010	2011	2012	2008-2012
Estonia	8.1	-4.2	-14.1	3.3	8.3	3.2	-0.7
Latvia	9.5	-3.3	-17.7	-0.9	5.5	5.6	-2.2
Lithuania	8.6	2.9	-14.8	1.5	5.9	3.6	-0.2
Baltic3	**8.7**	**-1.5**	**-15.5**	**1.3**	**6.6**	**4.1**	**-1.0**
Czech Republic	5.6	3.1	-4.5	2.5	1.9	-1.3	0.3
Hungary	3.3	0.9	-6.8	1.6	1.6	-1.7	-0.9
Poland	5.2	5.1	1.6	3.9	4.5	1.9	3.4
Slovenia	4.8	3.4	-7.8	1.2	0.6	-2.3	-1.0
Slovakia	7.0	5.8	-4.9	4.4	3.2	2.0	1.2
V5	**5.2**	**3.7**	**-4.5**	**2.7**	**2.4**	**-0.3**	**0.6**
Bulgaria	6.3	6.2	-5.5	0.4	1.8	0.8	0.7
Croatia	4.8	2.1	-6.9	-2.3	0.0	-2.0	-2.0
Romania	6.4	7.3	-6.6	-1.1	2.2	0.7	0.5
Balkan3	**5.8**	**5.2**	**-6.3**	**-1.0**	**1.3**	**-0.2**	**-0.3**
CEE11	**6.3**	**2.7**	**-8.0**	**1.3**	**3.2**	**1.0**	**-0.1**
EU	**2.5**	**0.3**	**-4.3**	**2.1**	**1.6**	**-0.3**	**-0.1**

Source: Eurostat

Investment

(In percentage to preceding year)

	2005-2007	2008	2009	2010	2011	2012	2008-2012
Estonia	13.9	-13.3	-38.3	-7.4	25.7	21.0	-2.5
Latvia	16.6	-13.8	-37.4	-18.1	27.9	12.3	-5.8
Lithuania	16.2	-5.2	-39.5	1.9	18.3	-2.5	-5.4
Baltic3	**15.6**	**-10.8**	**-38.4**	**-7.9**	**24.0**	**10.3**	**-4.6**
Czech Republic	5.6	4.1	-11.0	1.0	-0.7	-1.7	-1.7
Hungary	2.8	2.9	-11.1	-9.5	-3.6	-3.8	-5.0
Poland	8.9	9.6	-1.2	-0.4	8.5	-0.8	3.1
Slovenia	7.4	1.0	-19.7	6.5	14.2	-3.7	-0.3
Slovakia	7.4	1.0	-19.7	6.5	14.2	-3.7	-0.3
V5	**6.4**	**3.7**	**-12.5**	**0.8**	**6.5**	**-2.7**	**-0.8**
Bulgaria	16.3	21.7	-17.6	-18.3	-6.5	0.8	-4.0
Croatia	10.4	8.7	-14.2	-15.0	-6.4	-4.6	-6.3
Romania	16.8	15.6	-28.1	-1.8	7.3	4.9	-0.4
Balkan3	**14.5**	**15.3**	**-20.0**	**-11.7**	**-1.9**	**0.4**	**-3.6**
CEE11	**11.1**	**2.9**	**-21.6**	**-5.0**	**9.0**	**1.7**	**-2.6**
EU	**4.0**	**-1.1**	**-13.0**	**0.0**	**1.4**	**-2.8**	**-3.1**

Source: Eurostat

Private consumption

(In percentage to preceding year)

	2003-2007	2008	2009	2010	2011	2012	2008-2012
Estonia	5.4	-0.4	-5.7	0.5	-2.3	-0.9	-1.8
Latvia	12.6	-5.8	-22.6	2.4	4.8	5.4	-3.2
Lithuania	11.1	3.7	-17.8	-4.7	6.4	4.7	-1.5
Baltic3	**9.7**	**-0.8**	**-15.4**	**-0.6**	**3.0**	**3.1**	**-2.2**
Czech Republic	4.0	2.8	0.2	1.0	0.7	-3.5	0.2
Hungary	3.0	-0.7	-6.6	-3.0	0.5	-1.4	-2.2
Poland	3.7	5.7	2.0	3.1	2.6	0.8	2.8
Slovenia	3.5	2.3	0.1	1.3	0.9	-2.9	0.3
Slovakia	5.1	6.1	0.2	-0.7	-0.5	-0.6	0.9
V5	**3.9**	**3.2**	**-0.8**	**0.3**	**0.8**	**-1.5**	**0.4**
Bulgaria	7.8	3.4	-7.6	0.1	1.5	2.6	0.0
Croatia	4.3	1.4	-7.5	-1.3	0.2	-2.9	-2.0
Romania	11.7	9.0	-10.1	-0.3	1.1	1.1	0.2
Balkan3	**7.9**	**4.6**	**-8.4**	**-0.5**	**0.9**	**0.3**	**-0.6**
CEE11	**6.6**	**2.5**	**-6.9**	**-0.1**	**1.4**	**0.2**	**-0.6**
EU	**2.1**	**0.3**	**-1.5**	**1.1**	**0.1**	**-0.7**	**-0.1**

Source: Eurostat

Government consumption

(In percentage to preceding year)

	2003-2007	2008	2009	2010	2011	2012	2008-2012
Estonia	9.8	-5.2	-14.8	-2.4	3.5	4.4	-2.9
Latvia	12.6	-5.8	-22.6	2.4	4.8	5.4	-3.2
Lithuania	11.1	3.7	-17.8	-4.7	6.4	4.7	-1.5
Baltic3	**11.2**	**-2.4**	**-18.4**	**-1.6**	**4.9**	**4.8**	**-2.5**
Czech Republic	0.8	1.2	4.0	0.5	-2.5	-1.0	0.4
Hungary	1.0	1.1	0.7	-0.7	-0.3	-2.3	-0.3
Poland	4.6	7.4	2.1	4.1	-1.7	0.0	2.4
Slovenia	2.8	5.9	2.5	1.5	-1.2	-1.6	1.4
Slovakia	2.7	6.1	6.1	1.0	-4.3	-0.6	1.7
V5	**2.4**	**4.3**	**3.1**	**1.3**	**-2.0**	**-1.1**	**1.1**
Bulgaria	3.2	-1.0	-6.5	1.9	1.6	-1.4	-1.1
Croatia	3.5	-0.2	0.4	-2.1	-0.6	-0.8	-0.7
Romania	-0.1	7.2	3.1	-4.7	0.2	1.7	1.5
Balkan3	**2.2**	**2.0**	**-1.0**	**-1.6**	**0.4**	**-0.2**	**-0.1**
CEE11	**4.7**	**1.9**	**-3.9**	**-0.3**	**0.5**	**0.8**	**-0.2**
EU	**3.5**	**-0.2**	**0.4**	**-2.1**	**-0.6**	**-0.8**	**-0.7**

Source: Eurostat

Employment

(In percentage to preceding year)

	2003-2007	2008	2009	2010	2011	2012	2008-2012
Estonia	1.9	0.2	-10.0	-4.8	7.0	2.2	-1.1
Latvia	2.6	0.9	-13.2	-4.8	-8.1	2.6	-4.5
Lithuania	1.9	-0.7	-6.8	-5.1	2.0	1.8	-1.8
Baltic3	**2.1**	**0.1**	**-10.0**	**-4.9**	**0.3**	**2.2**	**-2.5**
Czech Republic	0.9	2.3	-1.8	-1.0	0.3	0.4	0.0
Hungary	0.0	-1.8	-2.5	0.7	0.4	0.1	-0.6
Poland	1.9	3.9	0.4	0.5	1.0	0.2	1.2
Slovenia	0.9	2.6	-1.8	-2.2	-1.6	-1.3	-0.9
Slovakia	1.3	3.2	-2.0	-1.5	1.8	0.1	0.3
V5	**1.0**	**2.0**	**-1.5**	**-0.7**	**0.4**	**-0.1**	**0.0**
Bulgaria	3.0	2.6	-2.6	-4.7	-3.4	-4.4	-2.5
Croatia	2.7	1.1	-1.8	-5.1	-2.3	-3.9	-2.4
Romania	-0.4	0.0	-2.0	-0.3	-1.1	1.9	-0.3
Balkan3	**1.8**	**1.2**	**-2.1**	**-3.4**	**-2.3**	**-2.1**	**-1.7**
CEE11	**1.5**	**1.3**	**-4.0**	**-2.6**	**-0.4**	**0.0**	**-1.1**
EU	**1.0**	**0.9**	**-1.9**	**-0.5**	**0.2**	**-0.3**	**-0.3**

Source: Eurostat

Unemployment rate

	2005-2007	2008	2009	2010	2011	2012	2008-2012
Estonia	7.6	5.5	13.8	16.9	12.5	10.2	11.8
Latvia	9.2	8.0	18.2	19.8	16.2	14.9	15.4
Lithuania	8.1	5.3	13.6	18.0	15.3	13.3	13.1
Baltic3	**8.3**	**6.3**	**15.2**	**18.2**	**14.7**	**12.8**	**13.4**
Czech Republic	7.3	4.4	6.7	7.3	6.7	7.0	6.4
Hungary	6.8	7.8	10.0	11.2	10.9	10.9	10.2
Poland	16.1	7.1	8.1	9.7	9.7	10.1	8.9
Slovenia	6.1	4.4	5.9	7.3	8.2	8.9	6.9
Slovakia	15.4	9.6	12.1	14.5	13.6	14.0	12.8
V5	**10.3**	**6.7**	**8.6**	**10.0**	**9.8**	**10.2**	**9.0**
Bulgaria	10.4	5.6	6.8	10.3	11.3	12.3	9.3
Croatia	12.2	8.4	9.1	11.8	13.5	15.9	11.7
Romania	7.1	5.8	6.9	7.3	7.4	7.0	6.9
Balkan3	**9.9**	**6.6**	**7.6**	**9.8**	**10.7**	**11.7**	**9.3**
CEE11	**9.7**	**6.5**	**10.1**	**12.2**	**11.4**	**11.3**	**10.3**
EU	**8.6**	**7.1**	**9.0**	**9.7**	**9.7**	**10.5**	**9.2**

Source: Eurostat

Exports of goods and services, volume

(Percentage change on preceding year)

	2003-2007	2008	2009	2010	2011	2012	2008-2012
Estonia	10.0	1.0	-20.6	22.9	23.4	5.6	6.5
Latvia	10.2	2.0	-14.1	11.6	12.7	7.1	3.9
Lithuania	8.9	11.4	-12.6	17.4	14.1	11.2	8.3
Baltic3	**9.7**	**4.8**	**-15.8**	**17.3**	**16.7**	**8.0**	**6.2**
Czech Republic	11.5	4.0	-10.9	15.5	9.4	3.8	4.4
Hungary	13.2	5.7	-10.2	14.2	6.3	2.0	3.6
Poland	11.9	7.1	-6.8	12.1	7.7	2.8	4.6
Slovenia	10.4	4.0	-16.7	10.1	7.0	0.3	0.9
Slovakia	13.6	3.1	-16.3	16.0	12.7	8.6	4.8
V5	**12.1**	**4.8**	**-12.2**	**13.6**	**8.6**	**3.5**	**3.7**
Bulgaria	10.3	3.0	-11.2	14.7	12.3	-0.4	3.7
Croatia	6.0	1.7	-16.2	4.8	2.0	0.4	-1.5
Romania	9.8	8.3	-6.4	13.2	10.3	-3.0	4.5
Balkan3	**8.7**	**4.3**	**-11.3**	**10.9**	**8.2**	**-1.0**	**2.2**
CEE11	**10.5**	**4.7**	**-12.9**	**13.9**	**10.7**	**3.5**	**4.0**
EU	**6.2**	**1.6**	**-11.7**	**10.7**	**6.4**	**2.3**	**1.9**

Source: Eurostat

Imports of goods and services, volume

(Percentage change on preceding year)

	2003-2007	2008	2009	2010	2011	2012	2008-2012
Estonia	12.9	-7.0	-32.0	21.0	25.0	9.1	3.2
Latvia	16.0	-10.8	-33.3	11.4	22.7	3.1	-1.4
Lithuania	13.0	10.3	-28.1	18.0	13.7	5.6	3.9
Baltic3	**14.0**	**-2.5**	**-31.1**	**16.8**	**20.5**	**5.9**	**1.9**
Czech Republic	9.3	2.7	-12.1	15.8	6.7	1.9	3.0
Hungary	11.6	5.5	-14.8	12.7	5.0	0.1	1.7
Poland	12.1	8.0	-12.4	13.9	5.5	-1.8	2.6
Slovenia	11.0	3.7	-19.5	7.9	5.2	-4.3	-1.4
Slovakia	11.0	3.1	-18.9	14.9	10.1	2.8	2.4
V5	**11.0**	**4.6**	**-15.5**	**13.0**	**6.5**	**-0.3**	**1.7**
Bulgaria	14.7	4.2	-21.0	2.4	8.3	3.7	-0.5
Croatia	7.1	4.0	-21.4	-2.8	1.3	-2.1	-4.2
Romania	20.8	7.9	-20.5	11.1	10.0	-0.9	1.5
Balkan3	**14.2**	**5.4**	**-21.0**	**3.6**	**6.5**	**0.2**	**-1.1**
CEE11	**12.7**	**2.9**	**-21.3**	**11.5**	**10.3**	**1.6**	**1.0**
EU	**6.5**	**1.1**	**-11.6**	**9.7**	**4.1**	**-0.3**	**0.6**

Source: Eurostat

Merchandise trade balance

(As percentage of GDP)

	2003-2007	2008	2009	2010	2011	2012	2008-2012
Estonia	-15.9	-12.5	-4.4	-2.7	-3.8	-6.8	-6.0
Latvia	-21.4	-17.8	-7.1	-7.0	-10.8	-9.8	-10.5
Lithuania	-12.0	-13.0	-3.3	-4.9	-5.9	-2.8	-6.0
Baltic3	**-16.4**	**-14.4**	**-4.9**	**-4.9**	**-6.8**	**-6.5**	**-7.5**
Czech Republic	0.6	0.6	2.3	1.4	2.3	3.9	2.1
Hungary	-2.9	-1.2	2.5	3.2	3.3	4.0	2.4
Poland	-2.4	-4.9	-1.0	-1.8	-2.1	-0.8	-2.1
Slovenia	-3.7	-6.6	-1.5	-2.9	-3.0	-0.9	-3.0
Slovakia	-3.7	-1.6	1.1	0.8	1.1	4.5	1.2
V5	**-2.4**	**-2.7**	**0.7**	**0.1**	**0.3**	**2.1**	**0.1**
Bulgaria	-19.3	-24.3	-12.0	-7.7	-5.6	-9.1	-11.7
Croatia	-21.4	-22.7	-16.5	-13.3	-13.9	-13.6	-16.0
Romania	-10.5	-13.6	-5.8	-6.1	-5.6	-5.6	-11.7
Balkan3	**-17.1**	**-20.2**	**-11.4**	**-9.0**	**-8.4**	**-9.4**	**-13.2**
CEE11	**-10.2**	**-10.7**	**-4.2**	**-3.7**	**-4.0**	**-3.4**	**-5.6**
EU	**-0.1**	**-1.1**	**-0.3**	**-0.5**	**-0.5**	**0.2**	**-0.4**

Source: Eurostat

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