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As time goes by...

Mixed showing after five years of EU eastern enlargement

May 1, 2004 saw the biggest round of EU enlargement with the accession of eight Central and Eastern European countries (CEEC) plus Malta and Cyprus. By and large, both sides' fundamental expectations of greater political stability and more dynamic growth have been fulfilled.

Today the EU is labouring under a lack of institutional modernisation since its biggest enlargement round, a growing clash of interests and the failure of its policy areas to focus sufficiently on the future. These are issues the member states will have to address once they have got to grips with their ongoing crisis management.

After five years of economic integration of the CEEC, we can strike a far more positive balance than the present mood of doom and gloom stemming from the global financial and economic crisis might suggest. Most of the CEEC, in particular the big and industrialised countries, have integrated successfully into the European division of labour and intra-EU trade with a range of global-standard export products, and they constitute important sales markets for the EU-15 countries.

The CEEC's track record on integrating into EU economic structures also clearly shows that this was the best substitute for a "Marshall Plan for Eastern Europe", which was debated in the mid-1990s. All CEEC have registered substantial prosperity gains in the course of their assimilation. What is more, those that have achieved broadly based economic integration and adopted the EU culture of stability are finding themselves far less hard hit by the financial and economic crisis than their CEEC peers.

The gravest financial and economic crisis since the beginning of transition is precisely what has breathed new life into faltering adoption of the euro in all CEEC. Given the very different economic situations in the individual CEEC, we expect step-by-step enlargement of the euro area in the coming years, with all eastern European members possibly having adopted the common currency by 2015. However, accession to the euro area should take place only after adequate structural preparation.

Authors
Barbara Böttcher
+49 69 910-31787
barbara.boettcher@db.com

Gunter Deuber
+49 69 910-31718
gunter.deuber@db.com

Editor
Maria Laura Lanzeni

Technical Assistant
Bettina Giesel

Deutsche Bank Research
Frankfurt am Main
Germany
Internet: www.dbresearch.com
E-mail marketing.dbr@db.com
Fax: +49 69 910-31877

Managing Director
Norbert Walter

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Reservations over enlargement...

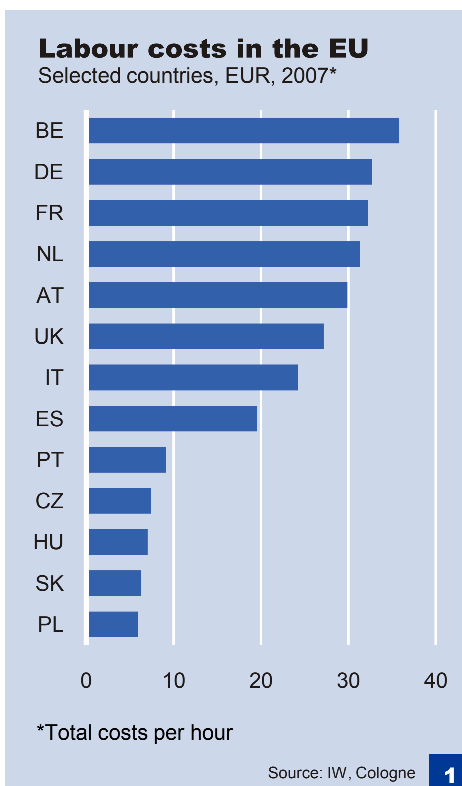
In September 2000 DB Research presented its first *EU Enlargement Monitor – Central and Eastern Europe*[1]. At that time popular support for this project of the century was cooling, both in the EU-15 and among the accession candidates themselves, albeit for different reasons. Even the political community was sending out contradictory signals. But what many people overlooked in the short-termist cost-benefit debate was that in the medium term the opportunities and advantages outweighed the negatives – as has now been borne out in hindsight.

... have not stood the test of time

But it was also clear that this quantum leap in the number of EU member states would involve an economic and political tour de force for all concerned. The two sides of the "EU coin", the candidates' eligibility and the EU's capacity for enlargement, demanded – and continue to demand – reform, new attitudes and above all an element of lockstep. This has not been as universally successful as necessary to capitalise fully on the enlarged EU's economic and political potential.

Not only have the new member states had to grapple with many ups and downs over the past decade, the Union has also reached impasses that it is finding very difficult to resolve. This paper focuses on the process of convergence so far in the larger Central and Eastern European countries (CEEC) and their medium-term prospects. The EU's experiences with this enlargement process will be touched on only marginally here.

The enlarged Union



When we speak of the EU's capacity for enlargement, essentially three main aspects are involved:

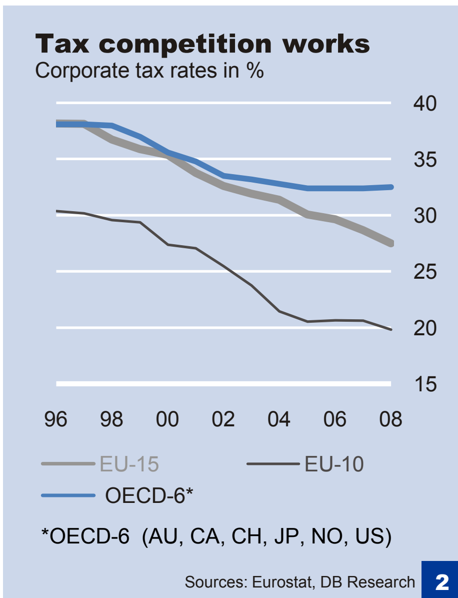
- first, the old member states' macroeconomic competitiveness (e.g. the flexibility of their labour markets, social systems and tax and contribution systems);
- second, the focus and financial viability of common EU policies (chiefly agricultural and structural policy), and
- third, the institutional structures (representation in EU institutions and decision-making processes).

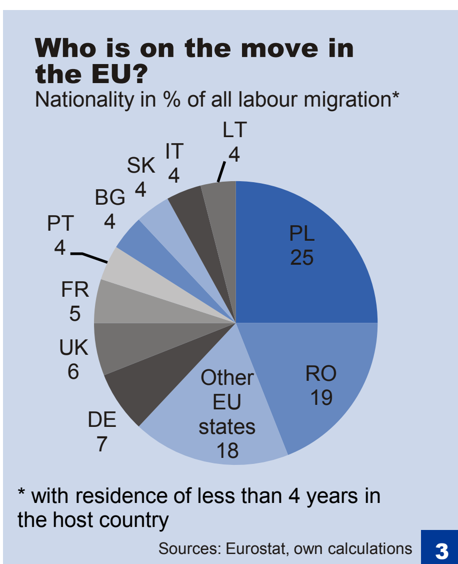
Strictly speaking, the first point is not a prerequisite for the Union's absorption capacity as such; but it does play an important part in terms of popular acceptance for enlargement and hence policy-makers' willingness to take the relevant decisions. In the run-up to eastward enlargement the predominant concerns voiced in public debate in the EU-15 were the possibility of job losses resulting from massive wage cost differentials, heightened competitive pressure from cheaper suppliers and a race to attract funding from commercial investors.

However, keener competition has not triggered any of the negative effects expected – quite the contrary. Even though the CEEC are comparative economic lightweights in the EU – gross domestic product has increased by a scant 7%, the population by 21% after enlargement – some quite considerable, prosperity-enhancing changes are apparent in the direction of trade and capital flows and the division of labour in the Union, particularly for the old member

[1] The *EU Enlargement Monitor* series was renamed *EU Monitor* after the final date for admission of the ten accession countries had been set at the December 2002 EU summit.

Old members benefit from larger internal market





Enlargement as budgetary challenge

states that share a border with the CEEC and whose cultural affinity gave them ready access to the markets of eastern Europe.[2] German industry, for one, has benefited enormously from the fast-expanding foreign markets 'on its doorstep', both through new sales opportunities and attractive production conditions. All in all, the resulting economic interlinkage has considerably helped German companies remain competitive even under the mounting pressure of globalisation and has enabled them to secure jobs.

What is more, the new member states' adoption of the rules governing the EU internal market guaranteed a level playing field, notwithstanding individual transitional provisions. However, the EU-15 missed the opportunity provided by enlargement to rid the *acquis communautaire*, the entire body of EU laws and regulations, of bureaucratic baggage by modifying and codifying legal texts or even expunging them entirely. It does not come wholly as a surprise that the European Commission's "Better Regulation" initiative launched later in this direction has so far failed to produce any tangible results.[3]

Many observers in the EU-15 expected free-market positions to play a greater part in shaping European economic policy following the accession of the CEEC countries, most of which were known to be hardened supply-side reformers. However, there are no signs of their having had any notable influence in this respect. The fact that the CEEC are not a uniform bloc of countries and did not therefore adopt a common stance, or indeed a common voice in voting on economic policy issues[4], in contrast to foreign and security policy for instance, will certainly have had something to do with this.

That said, the CEEC's investment-friendly policies designed to attract industrial settlement have fuelled tax competition in the European Union, causing old member states to lower their tax rates too and generally to improve the institutional framework for investment. However, the courage to implement reforms that the CEEC were expected to show was not matched on a similar scale by the old EU members. Not infrequently, necessary adjustment processes were put on hold by transitional arrangements, the most egregious example being the restriction on the free movement of labour, which can be kept in force until April 2011.[5] Yet the migration movements have proved to be far less than expected, and where no restrictions were imposed on entry positive growth effects have been observed.

Economic or 'transfer' union?

There was considerable doubt as to whether the EU would be financially overtaxed with an enlargement round of mainly poorer CEEC, some of whose economies were more predominantly agricultural. Concerns by the previous beneficiaries over reductions in their transfers were accompanied by the question of the EU's ability to absorb the new members. But with the net contributors in the Union continuing to insist that the financial framework 2007-2013 be capped at 1% of EU GDP, a cost explosion was averted as

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[2] See the comprehensive report by the European Commission: 'Five Years of an enlarged EU', Brussels 2009, on these economic implications as well as on the other aspects of enlargement.

[3] The European Council decided in March 2007 to cut the costs of bureaucracy by 25% by 2012.

[4] See Schneider, Ondrej (2008). Voting in the European Union – Central Europe's Lost Voice. CESifo Working papers No. 245.4.

[5] At present four of the EU-15, Austria, Belgium, Denmark and Germany, are still taking advantage of this option.

financial resources were partly redirected from old to new member states. [6] Whereas the financial transfers are extremely important to the new member states, in general the burden for the old members can hardly be described as onerous. At the end of the current budgetary period the transfers will reach 3% of CEEC GDP, while they will 'cost' the EU-15 a scant 0.3% of their GDP. In 2013 altogether 35% of EU expenditure will be channelled into the CEEC.

Modification of agricultural and structural policy, but…

To allay the fears mentioned, ahead of enlargement the EU-15 responded with moderate reforms and adjustments to the policies impacting on expenditure.[7] A marked shift took place in the *Common Agricultural Policy* (CAP) from price support measures to direct income support, which now accounts for around 70% of the CAP budget. To avoid offering any false incentives to structural change in the CEEC, the direct payments are being introduced and increased there step by step across the financial period. In *Structural Policy* co-financing rates have been adjusted, transfers are to be capped at 3% of national GDP, and support criteria have been modified. There are sound economic reasons for offering structurally weak members financial support (e.g. to prevent inadequate public infrastructure from acting as an impediment to private-sector investment) – which is not to say that high transfers are necessarily a guarantee of sustained economic development. Here, too, the crucial factor is to get the policy mix right and to use the funds to promote growth, with Greece and Portugal as negative examples of the axiom. For years, both have numbered among the biggest net recipients (relative to their GDP) without any lasting improvement in their economic position – quite the contrary. Even in the EU-25, Greece brings up the rear on indicators such as Economic Freedom (Fraser Institute) and Macroeconomic Competitiveness (WEF).

... no real refocus for the EU-27

However, the EU-15 have not seized the opportunity of enlargement to set a fundamentally new agenda. A comprehensive review of what tasks the EU is actually supposed to fulfil and, in a second step, how these are to be financed would have been the sensible approach, particularly where limited funding has to be shared out among competing objectives. CAP, for example, could have relied on more co-financing by the member states. Allocation of structural financial assistance geared to national rather than regional income would have been more constructive. It would also have greatly reduced the redistribution merry-go-round in the EU.[8] At the same time, the EU provides hardly any classic public goods that are available equally to all member states. The best examples are still the internal market and competition policy, both areas whose competences entail hardly any financial consequences. There are plenty of proposals on what a truly growth-oriented EU budget moving *inter alia* within the framework of the Lisbon strategy could look like.[9] [10] Admittedly, though, the chances of realising this in the enlarged Union have presumably become slimmer. By the same token, further accessions make conflicts in this respect a given.

Growth-oriented budget reform needed

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[6] Busch, Berthold (2008). Auswirkungen der EU-Erweiterung auf die Entwicklung und Verteilung des EU-Haushalts. IW-Trends. Cologne 2008.

[7] Whereby enlargement merely accentuated the problems with the two policies but did not cause them.

[8] Counting only the net recipients of the cohesion policy, the amount for 2006 would total not quite EUR 10 bn. Yet in 2006 the cohesion policy shifted EUR 32.4 bn. Busch (2008). op.cit.

[9] One of these is the Sapir Report. An Agenda for a Growing Europe. Oxford 2003.

[10] The European Commission plans to present a White Paper no later than October 2009 on a review of the EU budgetary framework examining all aspects of expenditure and revenues and containing proposals on a "modern" budget.

Enlargement with concomitant deepening – the great disillusionment

Enlargement has left the EU...

	...stronger	...weaker	...unchanged
EU-27	48%	36%	16%
EU-15	44%	40%	16%
12 new members	59%	21%	20%

Source: Eurobarometer survey December 2008

4

The pace of integration during the 1980s and 90s, when enlargement and deepening went hand in hand, could not be kept up. This is chiefly the fault of the EU-15 themselves, which passed up the chance of agreeing on the necessary institutional reforms while there were still fewer countries sitting round the table. Enlargement has again raised the number of potential nay-sayers, as demonstrated in the negotiations on the Treaty of Nice. What is more, in a difficult economic environment the populace in the old member states was highly nervous about the future of an enlarged Europe. The negative referendums in France and the Netherlands spelt the end of the Nice Treaty. Indeed, EU integration in general appears to have reached a level that some member states are finding difficult to handle. This is illustrated by the (second) Irish "No"-vote in the referendum on the Lisbon Treaty that was salvaged, following difficult negotiations, from the draft European Constitution. The Lisbon Treaty may have its weaknesses, but it does at least reform the voting rules and aim for more efficient decision-making structures.[11] After the welcomed positive vote of the Czech parliament, ways are currently being sought to bring the stalled ratification process to an end. Given the ongoing membership negotiations with Turkey and Croatia and the soon to be expected accession bid by Island, these efforts should be intensified in terms of content and speed.

Touch and go for Lisbon Treaty…

… and with it institutional modernisation of the EU

It is an open question whether the EU has sufficient political strength for a consensus solution. The size and homogeneity of a political and/or economic union play an important part in decision-making and in how the partners work together. Recent studies indicate that from a certain group size and member heterogeneity it is practically impossible to achieve majorities for the centralisation of policy areas and the delegation of sovereign rights. In addition to existing decision-making structures, this is due chiefly to strategic considerations in the choice of national negotiators at the supranational level.[12] To put it another way, the larger and more heterogeneous the group of countries, the more attention will be paid when delegating negotiators to adequate representation of (supposedly) national interests and to the provision of only limited public funds for policy coordination.

Institutional arrangements no substitute for political concord, but...

... make it vital to clarify positions

In a European Union of 27+ it will therefore hardly be possible to resolve the evident dilemma between enlargement and deepening. In 1999 the Copenhagen Criteria spelt out "the Union's capacity to absorb new members while maintaining the momentum of European integration" as an important consideration. But not being sufficiently specific, this soon fell off the radar amid rapid and extensive enlargement. Some new member states' attitude towards political integration (and the odd old member's, too) raises the question of whether sufficient common interests still remain to pursue a coherent common policy. In the wake of the economic and financial crisis, the possibility cannot therefore be ruled out of a revival in the

[11] Particularly with regard to the country weightings in voting by the Council of Ministers (double majorities), the number of commissioners, composition of the European Parliament and international representation of the EU.

[12] A. Alesina, I. Angeloni, F. Etro (2005). International unions. American economic Review 95, pp 602-615 and Lorz, Oliver and Willmann, Gerald (2008). Enlargement versus Deepening: The Trade-off Facing Economic Unions. CESifo working paper No. 2455.

debate over how to accommodate certain member groups' wishes for more intensive, institutionally underpinned cooperation.

The EU's modified enlargement strategy

Closer monitoring of negotiation progress sensible

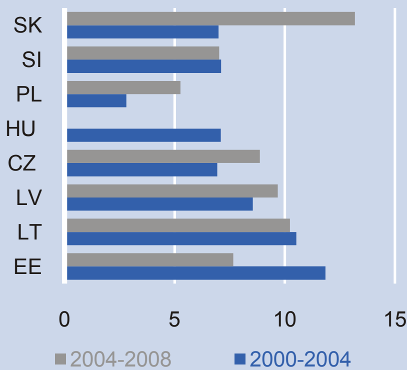
Experience with the major enlargement round has led the EU to define its enlargement strategy more specifically (see COM(2006) 649 final), which some potential candidate countries view as an unjustifiably restrictive policy. The new approach includes a detailed impact assessment of new accessions, which it presented for the first time in the case of Turkey (SEC(2004) 1202). Also, the *acquis* chapters are to be opened and negotiated one by one, with the EU members voting unanimously on their individual closure. Whilst this is certainly sensible, it does harbour the danger of blockades by individual countries over unrelated issues (e.g. Cyprus and negotiations with Turkey, Slovenia and negotiations with Croatia). But this also clearly highlights the necessity for the EU to insist on conflict resolution *before* countries are admitted to the Union, instead of internalising disputes with all the disadvantages this involves.

Ambitious benchmarking desirable

Additionally, readiness for accession and the progress made with negotiations on individual chapters are to be operationalised by setting specific benchmarks (along the lines of the Maastricht criteria, for example). Even if the ultimate decision on admission is, and should remain, a political one, binding, externally verifiable standards of this kind may serve to defuse political differences between the EU and accession candidates. However, care should be taken to define sufficiently ambitious benchmarks that take their lead from at least the EU average or from a certain group of countries rather than from the economically and/or politically weakest EU member in each case. Finally, no target dates are to be set for accession. When candidates are ready to join the Union should depend solely on actual progress in the negotiations.

Clear convergence towards EU-15

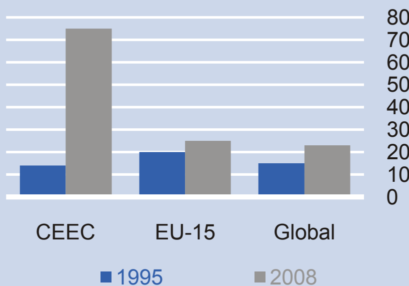
Change in GDP per capita at PPP in % of EU-15, percentage points



Sources: Eurostat, DB Research **5**

Dominance of foreign banks in CEEC

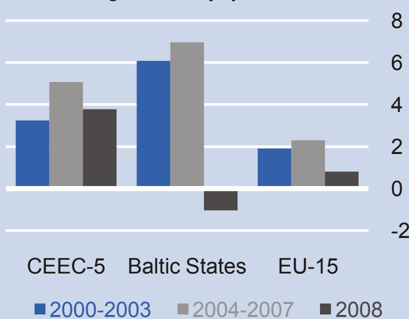
Foreign-owned banking sector assets, % of total assets



Sources: Bankscope, ECB, IMF **6**

Large growth differential between CEEC and EU-15

Real GDP growth, % yoy



Sources: National statistics, DB Research **7**

CEEC now fully integrated into the Common European Market

For years, the eight Central and Eastern European Countries from the 2004 EU enlargement round have focused on a special economic and development strategy of openness towards the west European EU member states resting on three main pillars: deep integration into Europe's division of labour, pronounced trade integration and a high level of financial market and financial sector integration. The fall of the Iron Curtain and its barriers to economic activity, and most importantly the EU accession process, offered the CEEC the chance of deep (re-)integration with their natural business partners.

The CEEC have registered their largest growth and prosperity gains since the late 1990s, lifting their share of (back-calculated) EU-27 GDP from around 4% in 2000 through 4.5% in 2004, the year of their accession to the Union, to roughly 5.7% in 2008. This economic dynamism is unquestionably linked to the prospect of EU membership opened up at that time. As they strove for inclusion in the EU, pivotal improvements were made in their institutional framework conditions. All the CEEC have succeeded in establishing themselves in the group of functioning market economies.[13] Poland, the Czech Republic and Hungary have belonged to the OECD since the mid-1990s and Slovakia joined the club in 2000. Estonia and Slovenia are in the process of accession. Above all, in the course of their transformation into market economies the CEEC have become important trade partners for the EU-15, which today source roughly 13% of their imports from the CEEC and ship 15% of their exports there. In the boom year 2007 the volume of trade between the CEEC and the EU-15 totalled some EUR 440 bn (with a surplus of about EUR 45 bn for the EU-15). The CEEC are far more dependent on this trade, their economic strength being considerably less. About 50% of CEEC external trade is conducted with the EU-15. This interdependence is similarly high in the banking sector. On average, foreign – most notably west European – banks hold 75% percent of the total assets of the banking sector in the CEEC. In the euro area countries, foreign-owned banks account for a market share of only 24%. European – mainly euro area – banks also hold a dominant position in cross-border lending to the CEEC, accounting for more than 90%. These high interdependencies are clearly indicative of the CEEC's positive economic integration into the EU.

20 years of economic transformation as an achievement

It is precisely because of their deep economic integration with western Europe that the CEEC have recently also felt the full force of the global financial and economic crisis gripping the EU-15. But the present pall hanging over the economic outlook in no way alters the CEEC's prospects of turning in further substantial prosperity gains, both in terms of absolute GDP levels and, most importantly, in per capita income terms. As far as per capita incomes on a purchasing power parity (PPP) basis are concerned, all CEEC regained their 1989 level between 1995 and 2000 with the exception

[13] Adoption of the body of EU legislation by the CEEC can be interpreted as the greatest institutional transfer in modern history. On this aspect see Schimmelfennig, Frank and Ulrich Sedelmeier (2005). The Europeanization of Central and Eastern Europe, Cornell University Press.

CEEC growth dynamic by comparison

	1999-2003	2004-2008
GDP growth, % yoy		
CEEC	3	5.9
EU-15	2.1	2
EM*	5	5.2
Macroeconomic investment, % of GDP		
CEEC	21.8	23.9
EU-15	20.9	21.4
EM	26	26.3
Macroeconomic savings, % of GDP		
CEEC	18.1	18.2
EU-15	21.2	21.9
EM	31.2	31.9
Current account, % of GDP		
CEEC	-3.7	-5.9
EU-15	0.3	0.4
EM	5.2	5.5
Imports of goods and services, % yoy		
CEEC	6.6	12.6
EU-15	4.6	5.7
EM	7.9	9.6
Exports of goods and services, % yoy		
CEEC	7.2	11.2
EU-15	5	5.9
EM	9.2	10.5

* Emerging and developing countries

Sources: Eurostat, IMF, DB Research 8

CEEC's top 3 trade partners

% of total exports, 2007

EE		LT		LV		CZ	
FI	17.5	RU	15.2	LT	14.8	DE	30.8
SE	13.8	DE	10.4	RU	13.1	SK	8.6
DE	5.0	PL	6.4	EE	13.1	PL	5.9
HU		**PL**		**SI**		**SK**	
DE	28.2	DE	25.9	DE	18.6	DE	21.4
IT	5.6	IT	6.6	IT	12.3	CZ	12.5
FR	4.7	FR	6.1	HR	8.2	FR	6.8

Source: Eurostat 9

of Hungary, which had seen hardly any decline before the mid-90ies. Since then they have notched up substantial prosperity gains. Today, per capita prosperity on a purchasing power parity basis is 30-50% above its 2000 level and fully 50-70% above the 1990 reading. This means that all CEEC have caught up significantly on prosperity in the EU-15 countries. In 2000 GDP-weighted per capita income in the CEEC on a PPP basis worked out at 47% of that in the EU-15. By 2004 it had climbed to 53% and now stands at 59%. Practically all CEEC are thus now high income countries as defined by the World Bank; indeed, the Czech Republic and Slovenia have already caught up with Portugal and Greece respectively. Only Latvia and Lithuania are still classified as upper middle income countries.

Integration review

The special anchor of EU membership not available to other emerging economies has enabled the CEEC to achieve the deep integration with the advanced economies of the EU-15 desirable from a developmental perspective. The transfer of institutions and credibility resulting from their accession to the EU has triggered long-term investment on a very considerable scale. Incorporation of the CEEC into the economic structures of the EU has therefore channelled substantial capital flows from the wealthy EU economies into productive and profitable use in the emerging CEEC.

Integration into the European division of labour

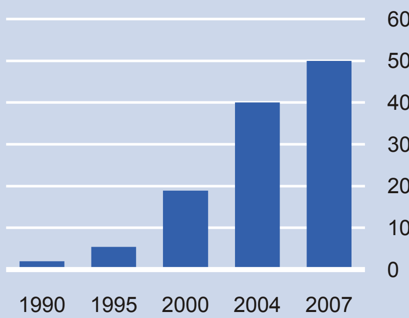
All CEEC, most particularly Estonia, Poland, the Czech Republic and Hungary, and later Slovakia as well, succeeded in attracting substantial inflows of foreign direct investment (FDI) prior to joining the EU. The FDI inward stock as a percentage of CEEC GDP climbed from less than 2% in 1990 to 5.4% in 1995, soaring to 18.9% in 2000. Four years later, in 2004 when the CEEC joined the EU, their inward FDI hit 40% of GDP, throwing the investment boom ahead of their EU membership into sharp focus. Today FDI as a percentage of GDP is a "mere" 10 points higher, at 50%. In spite of marked country-specific differences, inward FDI relative to GDP is considerably higher in most CEEC than the average for developed economies (27.2%) and emerging economies (29.8%).

The FDI boom in the CEEC was fostered by free trade agreements with the EU in the 1990s.[14] This early access to the EU's internal market enabled the CEEC to reap some of the prosperity dividend on EU membership stemming from free trade within the Union before their accession proper. What is more, the strong influx of FDI and the CEEC's associated integration into the division of labour in Europe led to a substantial transfer of know-how and technology within a short space of time. The exceptionally productive character of FDI inflows into Central and Eastern Europe is evident in the high proportion of FDI in gross fixed capital formation, the share of which rose from less than 5% in the early 1990s to around 20% in 2000. Since then the levels in most CEEC have ranged consistently between 20-30% – a much higher figure than in developed economies (10.3%) and other emerging markets (12.1%).

It is plain from the historical sequence of FDI penetration that important cornerstones of the CEEC's integration into the European

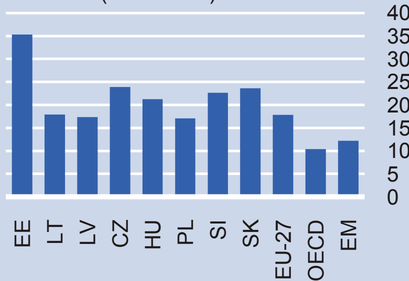
[14] In the period from 1991-1995 the EU granted all CEEC preferential access to its internal market through trade and cooperation agreements, also called European agreements.

FDI boom in CEEC
FDI stock of all CEEC, % of GDP



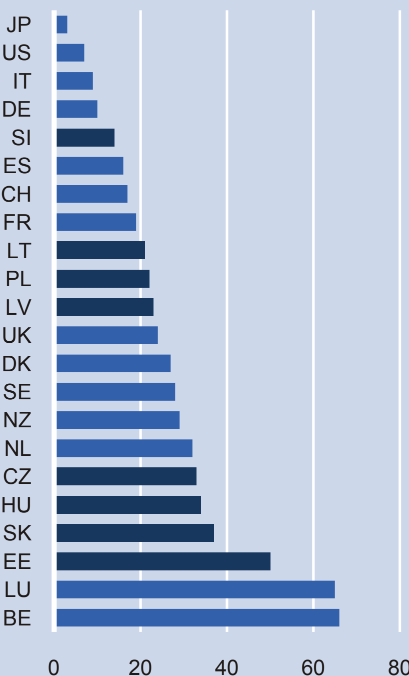
Sources: World Bank, DB Research **10**

Productive FDI in most CEEC
Percentage of ADI in gross fixed capital formation (2002-2007)



Sources: World Bank, DB Research **11**

CEEC among the most integrated industrial countries
World Bank Transnationality Index, 2007



NB: Average FDI inflow as percentage of gross fixed capital formation, FDI inward stock in % of GDP and foreign affiliates' share of domestic value added and employment in %.

Sources: World Bank, DB Research **12**

division of labour and international and European manufacturing networks were laid before they joined the EU – but with the clear perspective that they would satisfy the central accession criteria – because the bulk of FDI inflows during the investment boom originated from western Europe. The heavyweight European industrial nations, most notably Germany, set Central and Eastern Europe firmly on the road to integration, as we can see today in those countries' position as the chief trading partners of most CEEC. Having initially focused heavily on big industry and manufacturing, FDI increasingly turned its attention to the services sector.

With FDI penetration in the CEEC strongly motivated by production costs and the quest for new markets, it is logical that transnational and above all west European corporations are today among the companies with the highest revenues in the CEEC.[15]

The World Bank's Transnationality Index of leading FDI host countries among the developed economies clearly manifests the CEEC's especially close integration into the international – and in our context particularly the European – value chain. The index measures FDI inflows as a percentage of gross fixed capital formation, the FDI inward stock as a percentage of GDP and foreign affiliates' share of domestic value added and total employment. On these measures, the CEEC share top places with such internationally successfully integrated economies as Belgium, the Netherlands and Switzerland.[16]

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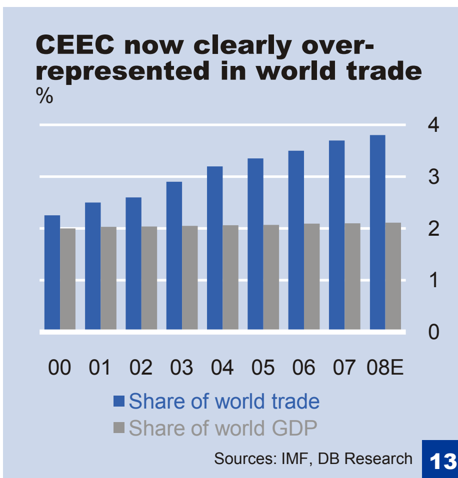
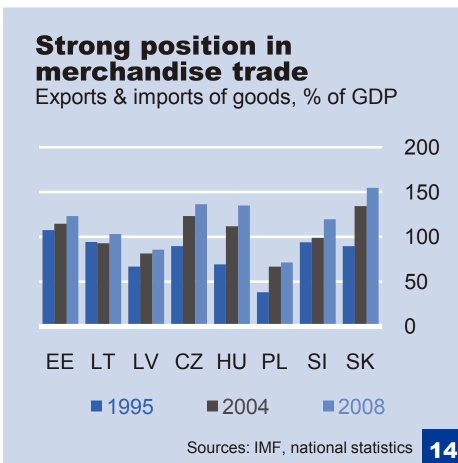
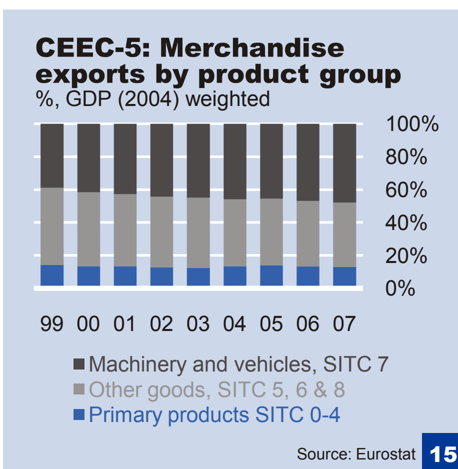
[15] Of the 25 companies with the highest revenues in the CEEC 19 are headquartered in western Europe. See Financial Times (2008). Top 500 Companies Central and Eastern Europe. Financial Times Special Report. September 11, 2008.
[16] World Bank (2008). World Investment Report 2008. p 12. New York.



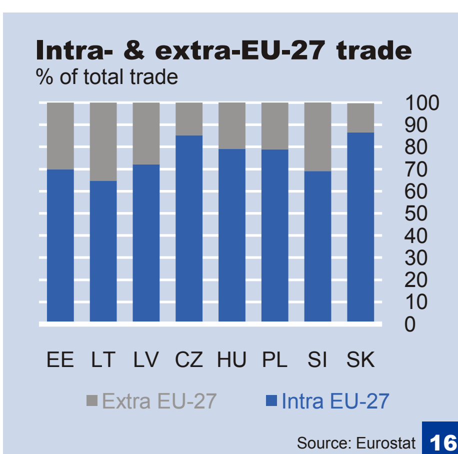
CEEC now clearly over-represented in world trade



Strong position in merchandise trade



CEEC-5: Merchandise exports by product group



Intra- & extra-EU-27 trade

Integration into intra-EU trade and world trade

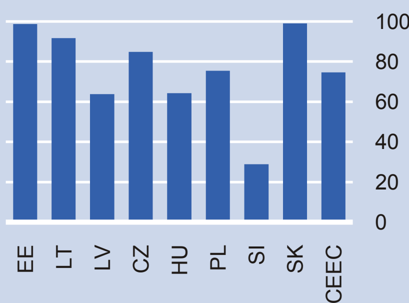
The investment boom triggered by the prospect of EU membership and the (re-)industrialisation to which this gave rise in most CEEC laid the foundation for their intensive integration into foreign and most particularly intra-EU trade. This can be gauged with reference to four central indicators: their steeply rising world market shares, their very marked trade openness in general, the large share of intra-EU trade in external trade and the high-quality range of export merchandise delivered by most CEEC.

The CEEC ramped up their share of world trade from just over 2% in 2000 to 3.8% in 2008, even though their share of world GDP during the same period ticked up only slightly from just under to just over 2%. These disproportionate gains in world market share were driven by a distinct increase in their trade openness. Since the mid-1990s the trade openness ratio (total exports plus imports as a percentage of GDP) has jumped from close to 100% to well over 100% in all CEEC with the exception of Poland as the only big economy and Latvia and Lithuania in the wake of the Russian crisis.

Ultimately, all CEEC owe their successful international trade integration to their more or less close assimilation into intra-EU trade. Gravitational considerations and the possibility of early participation in the single European market make this trade focus a logical one for the CEEC. Today their incorporation into the EU's internal market is comparable to the shares of intra-EU trade in the EU-15's foreign trade. Indeed, some CEEC can even boast a higher share than certain EU-15 states.

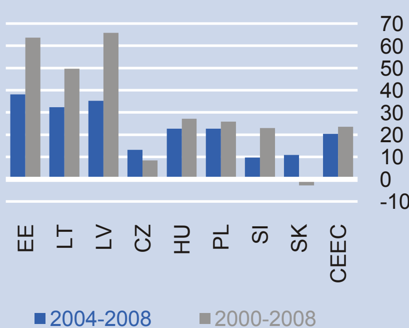
The dynamic development in foreign trade for most CEEC rests on their high international competitiveness. The successful CEE states have evidently managed to compensate increases in their real exchange rates, some of them steep, by considerably stepping up their productivity and product quality. This is most apparent in the structural upgrading of the export range towards labour-intensive and at the same time high-quality industrial goods in the CEEC-5 since the late 1990s. In the Czech Republic, Hungary, Poland, Slovakia and Slovenia the proportion of technology-intensive exports has risen steadily and sharply from an already high level. In addition to automobile production, the CEEC-5 have now secured substantial world market shares in mechanical and electrical engineering, electronics and pharmaceuticals. However, the intense focus on intra-EU trade and cyclical industries has left the CEEC considerably more vulnerable to external shocks such as a recession in western Europe.

Foreign-owned banks dominate CEEC
Foreign banks' share of total assets, %



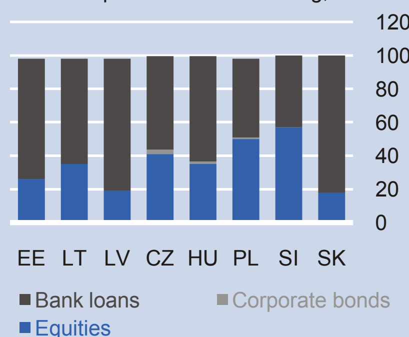
Sources: National central banks, DB Research **17**

Increase in financial intermediation
Change in stock of domestic credit in % of GDP, percentage points



Sources: IMF, DB Research **18**

Dominance of bank lending
Shares of private sector financing, %



NB: Data end-2006

Sources: BIS, IMF **19**

Integration into the European financial market

To tie into the international financial network and cope with the crises in their domestic banking sectors, the CEEC's central plan of action was to open up to strategic investors from abroad – even before joining the EU. Investors from the EU-15 states in particular were attracted by Central and Eastern Europe's underdeveloped financial intermediation, the liberalisation of its financial sector and capital account in the course of the EU accession process, and the prosperity gains anticipated from European integration, which was led chiefly in this sector by Italy, Austria, Germany and Sweden. Essentially, development of the CEE banking sector was driven forward by the substantial commitment of west European banks. Like FDI in the industrial sector, participation by foreign banks boosts technology and know-how (including risk management) and hence the creation of new products[17], promoting more efficient allocation of capital and the expansion of financial intermediation.

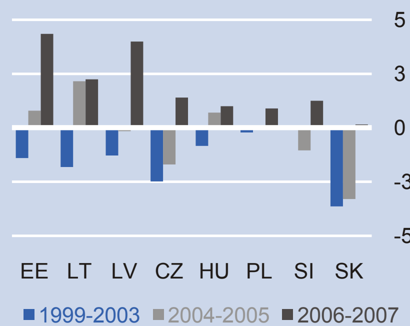
Particularly since EU accession, the scale of financial intermediation in the CEEC, measured as the stock of domestic credit as a percentage of GDP, has risen significantly. Between 2004 and 2008 it jumped by 20 percentage points from 45% to 65% for all the CEEC. This rapid expansion saw some CEE states achieving a degree of financial intermediation only shortly after joining the Union that is considered appropriate by international standards to emerging markets or even to developed economies.[18] Whether this credit boom would have been possible without foreign banks in the background is a moot point.

Although most CEEC are heavily reliant on bank lending because other types of finance are underdeveloped, in some countries the strong credit expansion was out of sync with national savings, the difference being made up by foreign parent banks or by borrowing on the international capital market. In expanding their financial intermediation through heavy external funding and debt financing, some CEEC have placed themselves in a position of dependence on the (net) influx of foreign capital. But capital flows into emerging economies in particular can quickly dry up as a result of erratic risk aversion on the capital market and institutional factors. Even the substantial commitment by banks from the EU-15 offers no automatic protection against such risk, given that the foreign banks are ultimately equally reliant on (re)financing in the capital market.

[17] For an in-depth analysis see Goldberg, Linda (2009). Understanding Banking Sector Globalization, IMF Staff Papers 56(1). pp. 171-197, International Monetary Fund (2007). Global Financial Stability Report 2007. pp. 99-127. With particular focus on the CEEC see European Bank for Reconstruction and Development (2006). Transition Report. London. pp. 58-67.

[18] Backe, Peter, Egert, Balazs and Tina Zumer: Credit Growth in Central and Eastern Europe: New (Over)Shooting Stars? In Oesterreichische Nationalbank (2006). Focus on European Economic Integration 1/06, pp. 112-139. Vienna.

Growth above potential in CEEC – except Slovakia
Output gap, % of potential output



Sources: ECB, DB Research **20**

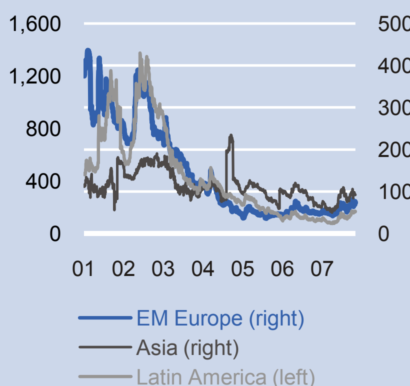
Moreover, the combination of a real post-EU-accession boom and a positive global economic and capital market environment fuelled excessive exuberance in some CEE banking sectors. The resultant generous supply of low-interest loans in these CEEC encouraged domestic overheating, with the attendant external imbalances. As a result, all the CEE states have expanded above their potential rate of growth in recent years – some, notably the smallest economies, on a significant scale, as indicated by the consideration of potential growth in the ECB's convergence reports.[19]

Key CEE banking sector data

	EE	LT	LV	CZ	HU	PL	SI	SK	CEEC
Total assets banking sector, % of GDP (2008)	132	85	153	104	108	73	130	91	93
Stock of domestic credit, % of GDP (2008)	99	66	89	58	81	60	66	54	65
Change 2004-2008, percentage points	38	32	35	13	23	23	10	11	20
Change 2000-2008, percentage points	64	50	66	8	27	26	23	-3	23
Stock of domestic credit, % yoy (2000-2004)	28	29	40	2	13	8	18	7	10
Stock of domestic credit, % yoy (2004-2008)	29	36	39	13	16	22	25	16	20
Share of foreign banks (2004-2008)	99	92	58	85	73	74	25	98	75
Bank loan-to-deposit ratio, % (2008)	180	200	295	90	160	110	140	95	125
Foreign currency loans, % of all loans (2008)	87	63	90	n.a.	68	35	n.a.	n.a.	33
Foreign currency deposits, % of all deposits (2008)	30	22	59	n.a.	21	13	n.a.	n.a.	12
External assets and liabilities, % of GDP	295	163	261	169	340	145	240	162	196
Total ROA (2004-2008)	2.1	2.2	1.8	1.3	1.8	1.6	1.1	1.2	2
Core capital to risk-weighted assets, % (2008)	18	12.6	12.2	12.3	10.8	11.8	11.8	12.2	12
Non-performing loans, % total loan portfolio (2008)	2.6	4.3	3	2.9	3	4.9	2.9	3	4

Sources: IMF, national central banks, DB Research **21**

Falling risk premiums for emerging markets
EMBIG EUR, bp vs. Bunds



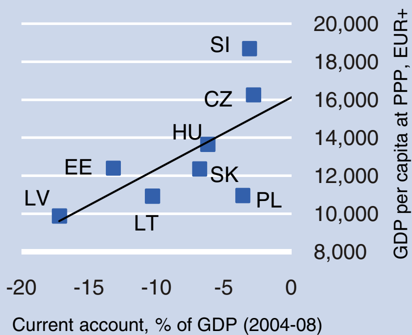
Sources: JP Morgan, DB Research **22**

Speed limits also apply in the EU

In spite of the fundamental sustainability of the CEE states' economic and development model and their potential for higher trend growth rates, it is clear that "natural" convergence speed limits exist, and that incorporation into the EU is absolutely no safeguard against economic overheating.[20] The latter is particularly relevant to the CEEC with their long pent-up consumer demand and a perceived need to catch up through their EU membership. But despite lower prosperity levels, annual GDP growth rates well above potential still lead to economic overheating, and neither EU nor euro area membership reduces the long-term burden of (reform) costs. EU membership itself and the acquisition of large stakes by foreign banks from advanced economies can "only" smooth adjustment

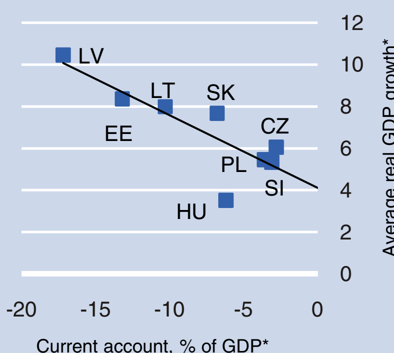
[19] European Central Bank (2008). Convergence Report May 2008. Frankfurt.
[20] As some EU-15 countries discovered in the course of integrating into the EU and/or the euro area. See Brzoza-Brzezina, Michal (2005): Lending booms in the New EU Member States. ECB Working Paper 543.

Catch-up encourages external imbalances



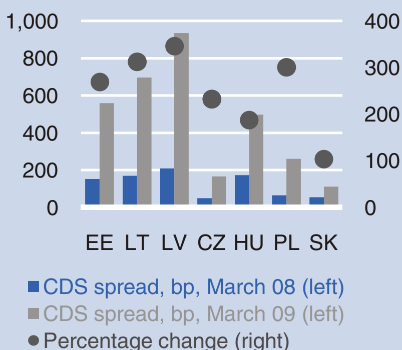
*2004. Sources: Eurostat, DB Research **23**

Strong growth – high imbalances



*2004-2008. Sources: Eurostat, DB Research **24**

Risk repricing in the CEEC



NB: Slovenia not available.

Sources: Bloomberg, DB Research **25**

without substantial capital outflows and balance of payments crises.[21]

The special capital market environment over the past few years acted as an important catalyst to overstepping the “speed limit”. Risk premiums on the capital flowing into emerging markets had dropped to extremely low levels – particularly so for the CEEC after their EU accession in 2004 and up until the international capital markets began repricing risks as a result of the 2008 and 2009 global financial and economic crisis. The positive global capital market situation and the expectations of exchange rate stability (or indeed ongoing currency appreciation) that it nurtured additionally explain the high proportion of foreign currency debt in some CEEC. Raising foreign currency loans when global capital markets are favourable and domestic interest rates higher is a common and rationally explicable phenomenon in emerging markets in the short term. Despite the steady stream of warnings in recent years about the dangers to the economies and financial sectors of Central and Eastern Europe from the rapid rise in financial intermediation, the systemic risks from this headlong expansion only began to unfold as a result of the external shock from the global crisis in 2008 and 2009.[22]

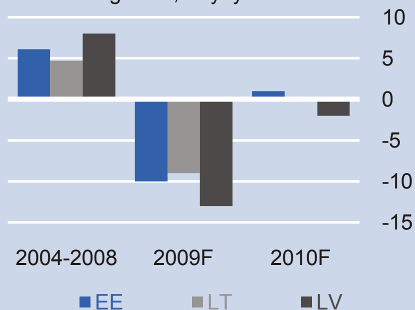
Short-term outlook: big differences between individual CEEC

The CEEC that focused disproportionately on bringing forward potential prosperity gains from their EU membership through credit-based expansion – in some cases without the productivity increases to match – face the prospect in the coming years of painful wealth losses. Their scale will be on a par with the transition shocks at the beginning of the 1990s with negative GDP growth in the high single-figure or even in the double-digit range. Changes in per capita income in these CEE states in 2009 and 2010 will thus fall significantly behind the average of the EU-27 and EU-15. This means that the differences between the individual CEE states already noticeable in 2008 and 2009 will persist in the coming years. In the Baltic States and Hungary the present crisis constitutes more than just a cyclical downswing. More trenchant adjustments are required there to correct a situation in which the private and/or public sectors have been living beyond their means for years. In the Czech Republic, Poland, Slovakia and Slovenia we see real convergence remaining intact even during the present crisis. These four economies will probably contract less in 2009 and 2010 and bounce back more quickly than most of the big western European EU members. The quartet does not exhibit any pronounced macroeconomic imbalances and is structurally well ranged for a coming economic upswing since its close trade integration with the core European economies rests on a modern industrial base. For these four

[21] This was highlighted by the ECB’s liquidity support for Poland and Hungary, the EU’s substantial assistance to Hungary and Latvia in the framework of IMF stand-by agreements and the west European banks’ clear commitment thus far to their affiliates in the CEEC. EU institutions and EU member states made EUR 5.4 bn available for the international aid package for Latvia, while the IMF and World Bank stumped up “only” EUR 2.1 bn. As part of the EUR 20 bn aid programme for Hungary the EU contributed EUR 6.5 bn.

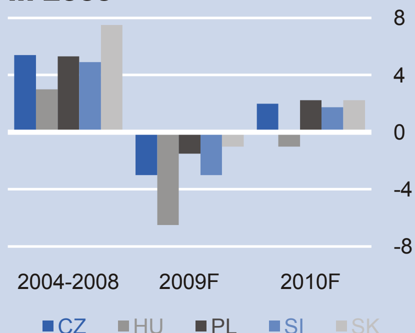
[22] See the European Central Bank convergence reports from 2006 and 2008 and Klett, Bernd and Marion Mühlberger (2007): Overheating concerns intensify, Credit Monitor Eastern Europe. Deutsche Bank Research. Frankfurt. Am Main. April 5, 2007 and Nestmann, Thorsten and Marion Mühlberger (2007): Eastern Europe: funding and liquidity risks have risen. Deutsche Bank Research. Credit Monitor Eastern Europe. Frankfurt am Main. November 6, 2007.

Baltic states in for hard landing in 2009 & 2010
Real GDP growth, % yoy



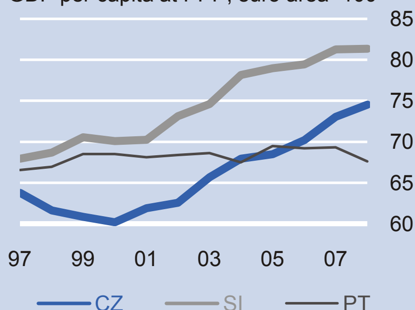
Sources: Eurostat, DB Research **26**

Sharp CEEC-5 downswing in 2009



Sources: Eurostat, DB Research **27**

EU no automatic convergence trigger
GDP per capita at PPP, euro area=100



Sources: DB Research, Eurostat **28**

countries the current crisis marks a cyclical downswing following a process of strong catch-up.

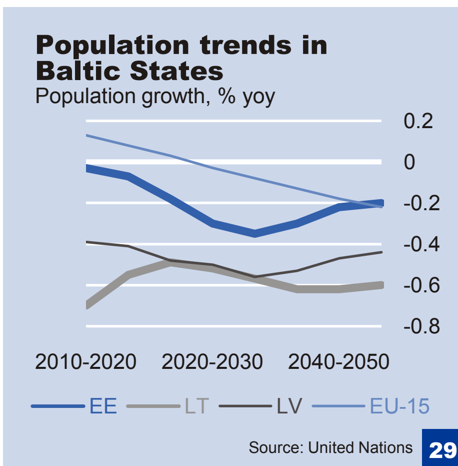
Long-term outlook

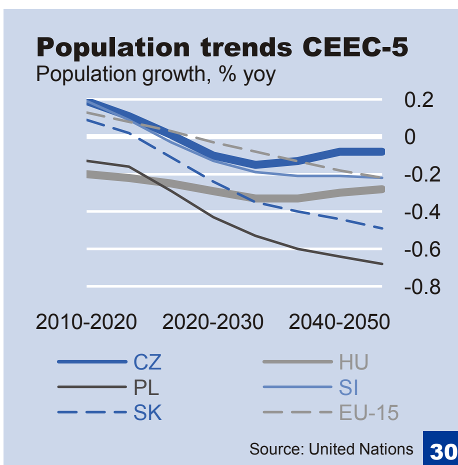
At present the eight CEEC from the 2004 enlargement round stand for about 5.7% of EU-27 GDP and for 9% calculated in purchasing power parities; but they represent 15% of the EU-27 population. This difference and the possibility of the CEEC continuing to benefit from Europe's internal market offers potential for further catch-up in Central and Eastern Europe. In the medium to long term, despite the present cyclical downturn and subject to the CEEC following solid expansion paths and maintaining their international competitiveness, they stand a good chance of further economic convergence. However, the need to place convergence on a suitable macroeconomic and structural foundation, which has clearly emerged in this study, also means that the possibility of rapid and easy harmonisation as part of the EU "convergence club" should not be overestimated. Certainly, the Union has in the past demonstrated its expertise in raising less developed economies to a considerably higher level of prosperity. But EU membership does no more than establish the institutional framework for positive long-term economic development. Turning this to good use is the responsibility of each individual member. Mere membership in the Union does not automatically imply long-term economic convergence towards average income levels in Europe, as starkly underlined by the pronounced and persistent income gaps among the EU-15. This aspect is particularly relevant to the CEEC. Both their population's expectations and the macroeconomic beta-convergence models often used for projections build implicitly or explicitly on the assumption of complete and quasi-automatic convergence to average levels in the EU-27 (or indeed the euro area).

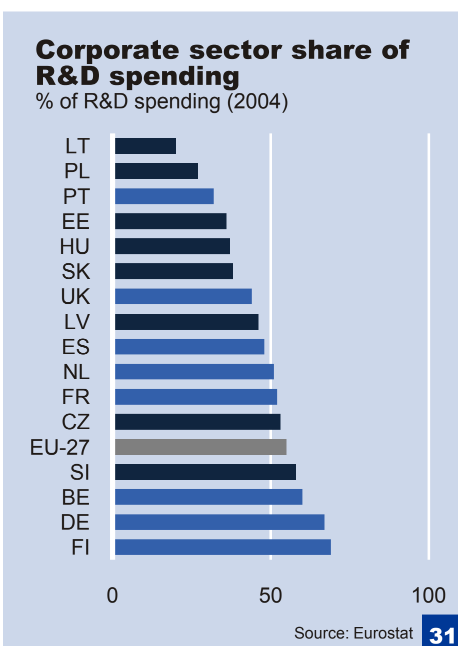
Simple growth drivers exhausted

Even the hitherto successful CEEC cannot therefore rest on their transition laurels, particularly since simple growth accelerants such as increasing financial intermediation or harmonisation with the *acquis communautaire* have largely been played out. The CEEC have also made good the under-representation in world trade, intra-EU trade and European company groups that they exhibited at the beginning of transition. Further trade share gains can now be carved out only with a marked increase in productivity, which will essentially result from more knowledge-intensive production and innovation – particularly in the light of the extremely negative demographic outlook in all CEEC.[23] So far the CEEC, in particular the CEEC-5, have specialised in labour-intensive sectors with high technology intensity and medium knowledge intensity. This was necessary to preserve or develop their industrial base. But the reservoir of sufficiently qualified labour for this kind of specialisation was already drained dry in the last boom. This bottleneck factor throughout the CEEC shows that the potential for extensive reindustrialisation or indeed further expansion is practically exhausted across the present production structure. And the CEEC will even have difficulty maintaining their present output and industrialisation position further

[23] All CEEC have a considerably worse demographic outlook both in comparison to other emerging economies and relative to most of the EU-15 countries. Across all the CEE states the total population and, even more importantly, the potential size of the working age population will shrink appreciably in the long term. See World Bank (2007). From Red to Gray: The "Third Transition" of Aging Populations in Eastern Europe and the Former Soviet Union. New York.







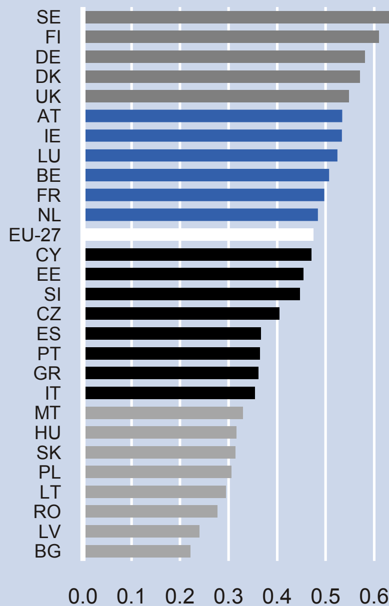
down the line as they come up against stiff competition from other emerging markets within or outside the EU whose cost structures may be more favourable in the long term.

To withstand the competitive pressure, keeping CEEC taxes at their present attractively low level would constitute an important competitive edge within the EU. This should be possible for most CEEC in the coming years. But the pressure to hike taxes should not be underestimated. The recent boom years made revenue-based fiscal consolidation possible. But going forward, spending cuts and selective tax increases to strengthen the tax base cannot be entirely ruled out – particularly if some CEEC fail to implement further reform of the cost structures in healthcare and nursing care.

No rapid deindustrialisation

Even if the potential for extensive growth strategies has been depleted, concerns over rapid deindustrialisation in the CEEC would be exaggerated. Central and Eastern Europe's good infrastructural development – at least in the industrial centres – and relatively low transport costs for west European companies, together with the comparative modernity of production plants installed during the FDI boom, will continue to make the region an attractive production location for European manufacturing networks. And in the long term, further economic advances by the CEEC may make them more attractive as work and/or migration destinations inside and outside the EU, countering the negative demographic trend.

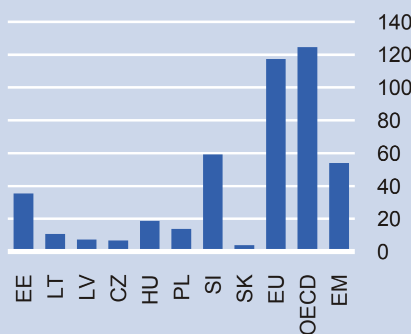
EU-27 innovation performance ranking 2008
Summary Innovation Index (SII) 2008, European Innovation Scoreboard, normalised between 0 and 1



Innovation leaders
Innovation followers
Moderate innovators
Catching-up countries

Source: Pro Inno Europe, Inno Metrics 32

CEEC short on outward FDI
FDI stock abroad, % of inward ADI



Sources: World Bank, DB Research 33

R&D and EU funds as growth drivers

To generate further growth, complex institutional improvements will have to be made in all CEEC in a bid to raise productivity and output and boost their innovative capacity. We consider most CEEC comparatively well positioned to step up their value added, develop knowledge-intensive production, strengthen knowledge-based and production-related services and become more innovative relative to their current economic capacity. This is despite the fact that none of the CEEC currently features among the most innovative country groups on the European Innovation Scoreboard (EIS) and, on a cross-sectional comparison of the EU-27, they also tend to languish in the lower middle range or at the bottom end of the scale in terms of R&D spending as a percentage of GDP.[24] Despite their present lukewarm EIS performance and the need for catch-up on R&D and education spending, we nevertheless consider some CEEC well equipped to switch to a development model of more intensive and higher-quality growth in future owing to their solid position in the innovation drivers education and R&D. The CEEC have already overtaken some EU-15 states in respect of education and training. With regard to R&D, two pivotal aspects are worth emphasising. First, the private sector in Central and Eastern Europe contributes a substantial share of the total R&D spend, and second employment in R&D as a percentage of total employment is already close to the EU-27 average. In the Czech Republic, Hungary, Poland and Slovakia the capital city regions already belong to the leading 15 EU regions in terms of the share of R&D personnel in total employment. It is precisely the private sector's commitment to R&D activities that can facilitate the implementation of research results into marketable products.

More efficient use of EU funds within the scope of the present Financial Framework (2007-2013) will also be of relevance to the CEEC's medium-range perspective. EU financial support concent-rates on such important areas as infrastructure, the rehabilitation of run-down energy sectors, education and research. Consequently, more targeted use of EU funding could improve the quantity and quality of government spending – with the input of less own funds. In going down this route the CEEC could generate an annual stimulus of 2-4% of GDP up to 2015 (in case all available EU funds could be absorbed)[25].

CEEC need to go more global

Central and Eastern Europe should also reconsider its strong focus on the EU, in favour of seeking increasing opportunities in non-European markets. CEEC companies could enjoy comparative advantages in products suited especially to emerging economies, particularly since this would enable them to pick up on traditional economic relations from before the 1989/1990 political turnaround. The plant construction and mechanical engineering industries from the CEEC-5, for example, delivered many products to former socialist "brother countries", and the need for replacements will arise. Widening their horizon beyond the EU would be particularly important for the CEEC which already invest abroad – the more so

[24] The EIS classifies only the Czech Republic, Estonia and Slovenia as innovation followers or moderate innovators. In this ranking Hungary, Latvia, Lithuania, Poland and Slovakia belong to the weakest group of catching-up countries.

[25] Vienna Institute for International Economic Studies, Monthly Report No. 8/9 – 2008, pp. 12-20.

since almost all CEEC have a lot of ground to make up in terms of outward FDI.

EMU accession as growth accelerator…

… given sufficient structural preparation

Although we see simple growth accelerators from EU membership as having been largely exhausted for the CEEC, one catalyst does remain – membership of European Monetary Union. Slovakia and Slovenia, who have already joined the euro, can benefit from the positive effects of their membership through further stability-oriented policies and from enlargement of the euro area by the accession of further CEEC. All those who have not yet signed up could be given a lift from credible policies in the path to the euro area. After an analysis of the CEEC's macroeconomic stability, external viability and integration into the European division of labour in the following section, we will turn to introduction of the euro in Central and Eastern Europe.

CEEC overview

Core economic indicators (averages 2004-2008)	EE	LT	LV	CZ	HU	PL	SI	SK
GDP growth rate, %	6.1	4.7	8.0	5.4	3.0	5.3	4.9	7.5
GDP per capita in EUR, PPP	15,341	13,330	12,419	18,529	15,024	12,506	21,170	15,094
Unemployment rate in %	7.1	7.4	8.0	7.2	7.1	15.1	5.9	14.8
Consumer Price Index, % yoy	5.7	4.7	9.0	3.3	4.9	2.7	3.2	4.4
Budget deficit in % of GDP	1.3	-1.2	-0.9	-2.3	-6.5	-3.6	-1.2	-3.1
Current account in % of GDP	-13.2	-10.3	-17.2	-2.8	-6.2	-3.6	-3.1	-6.8
Government debt in % of GDP	4.3	17.8	12.0	29.5	64.0	46.1	26.0	33.5
Foreign debt in % of GDP	98.3	65.7	116.0	39.6	90.8	50.5	22.4	56.7

International competitiveness*	EE	LT	LV	CZ	HU	PL	SI	SK
Effective exchange rate, 2008 vs. 2004, % change	17.6	14.0	26.0	33.6	16.7	24.9	4.0	43.5
Exports in % of GDP	75.6	48.3	42.6	74.9	73.9	40.0	67.0	79.7
Exports, % yoy	21.7	26.1	25.3	25.0	18.8	25.7	21.3	25.7
Labour productivity (EU-15=100)	55.1	51.5	45.0	63.8	65.8	57.8	75.9	64.9
Unit labour costs (2000=100), percentage points yoy	8.9	-2.8	17.8	0.4	4.1	1.9	-0.6	0.3

*=averages of the years 2004-2008 (exception: exchange rate)

Science & technology	EE	LT	LV	CZ	HU	PL	SI	SK
R&D expenditure in % of GDP, 2005	0.9	0.8	0.6	1.4	0.9	0.6	1.2	0.5
Share financed by business enterprises (in %), 2004	36	20	46	53	37	27	56	38
Percentage of R&D personnel in persons employed, 2004	1.3	1.2	0.8	1.3	1.3	0.9	1.1	1.0
Public expenditure on (tertiary) education in % of GDP, 2004	0.9	1.1	0.7	1.0	1.0	1.2	1.4	1.0
Graduates from tertiary education in % of 25-29 year-olds, 2005	12.6	18.4	16.5	6.3	9.0	17.0	10.2	7.8
High-tech exports in % of total exports, 2005	10.3	3.2	3.2	11.7	19.7	3.2	4.3	6.4
World market share of high-tech exports (in %), 2005	0.04	0.02	0.01	0.50	0.68	0.16	0.05	0.11
European Innovation Scoreboard (EIS) 2008, Summary Index, ranking in EU-27	13	24	26	15	21	23	14	22

Sources: Eurostat, DB Research 34

The CEEC in detail

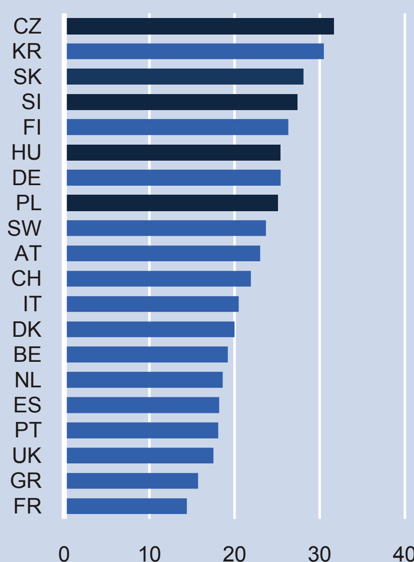
Core economic indicators

Czech Republic	1999-2003	2004-2008
GDP growth, % yoy	2.6	5.4
GDP per capita in EUR, PPP	13,792	18,529
Unemployment rate, %	8.1	7.2
Inflation, % yoy	2.5	3.3
Budget deficit, % GDP	-5.3	-2.3
Current account, % GDP	-4.9	-2.8
Government debt, % GDP	23.7	29.5
Foreign debt, % GDP	37.0	39.6
Exchange rate vs. EUR	34.3	28.0

Sources: Eurostat, DB Research 35

CZ leading industrial nation in EU and OECD

Industry output, % of GDP (2006)



Source: OECD 36

Int. competitiveness*

Czech Republic	1999-2003	2004-2008
Effective exchange rate, %**	13.5	33.6
Exports in % of GDP	61.2	74.9
Exports, % yoy	11.3	25.0
Labour productivity (EU-15=100)	56.2	63.8
Unit labour costs, % yoy	8.5	0.4

*=averages of the years 2004-2008 & 1999-2003 (exception: exchange rate). ** 2003 vs. 1999 & 2008 vs. 2004

Sources: Eurostat, DB Research 37

Czech Republic (CZ)

In the process of integrating into the EU, the Czech Republic succeeded in preserving its high level of industrialisation. It is therefore hardly surprising that the country was already a major target destination for FDI back in the 1990s and can now boast the highest FDI stock per capita of all CEEC.

Even before EU accession, a very solid macroeconomic environment and wage increases in step with productivity growth were conducive to booming FDI and industrialisation. The Czech macroeconomic dataset, like that in Slovenia, is therefore the soundest of all the CEEC. Since the mid-1990s inflation has fallen to low single-digit levels and the central bank has established itself as an independent and credible institutions. Since joining the EU, budget deficits have receded to Maastricht-compatible levels.

With domestic interest rates low, foreign currency lending has not become widespread in the Czech Republic, the more so since financial intermediation has expanded moderately, even since EU membership. Between 2000 and 2008 domestic lending as a percentage of GDP climbed only eight percentage points to 58%. This encouraged more moderate growth in domestic demand in line with overall output growth, which has kept the current account deficit at single-figure levels (as a percentage of GDP). Particularly on the trade side, since its EU membership the country has been able to reap the rewards of successful economic integration. Today the Czech Republic is one of the most integrated economies within the Union, with intra-EU trade accounting for 85% of its total trade.

Although the Czech Republic will have difficulty in the long term in maintaining its level of industrialisation, we consider it well ranged to boost domestic output and to develop business sectors closely related to its solid industrial base. Together with Slovenia, it is the most innovative of the CEEC economies, exhibiting a large proportion of high-tech exports in its total shipments. R&D spending and private sector participation in this are among the highest in the region.

Given such a sound macroeconomic background, it is surprising that a country which would in fact have been eligible to join the euro has not pursued any clear strategy in this respect in recent years. Its abstention can be explained primarily by central bank and government preference for the preservation of monetary autonomy during the convergence process and the president's fundamental opposition. With the level of prosperity now achieved and the country's record of monetary and fiscal stability bias, the Czech Republic's accession to the euro area – following the membership of ERM II on which this is conditional – would appear to be the next logical step.

Estonia (EE)

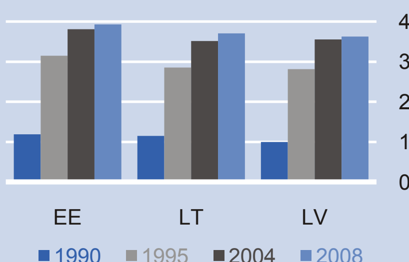
In the 1990s Estonia shone as a CEEC reform star. Today, its international trade integration puts it on a par with the most integrated economies among the CEEC-5. As a result of its specialisation in services, often back-office support and services for international or Nordic companies, Estonia can even lay claim to the highest share of services trade, as a percentage of GDP, in any CEEC and has been the only member of that group to generate surpluses for years.

Core economic indicators

Estonia	1999-2003	2004-2008
GDP growth, % yoy	6.4	6.1
GDP per capita in EUR, PPP	9,342	15,341
Unemployment rate, %	11.4	7.1
Inflation, % yoy	3.6	5.7
Budget deficit, % GDP	-0.4	1.3
Current account, % GDP	-7.4	-13.2
Government debt, % GDP	5.4	4.3
Foreign debt, % GDP	54.1	98.3
Exchange rate vs. EUR	15.6	15.6

Sources: Eurostat, DB Research 38

EE: No. 1 Baltic State in EBRD Reform Index

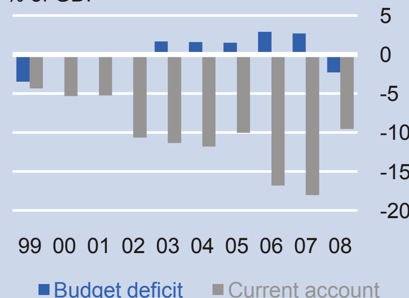


The scale ranges from 1 to 4.0. A value of 4.0 stands for the successful transition to a fully functioning free market economy as defined in the index categories.

Sources: EBRD, DB Research 39

EE: Imbalances despite restrictive fiscal policy

% of GDP



Sources: Eurostat, DB Research 40

Int. competitiveness*

Estonia	1999-2003	2004-2008
Effective exchange rate, %**	7.3	17.6
Exports in % of GDP	73.9	75.6
Exports, % yoy	11.7	21.7
Labour productivity (EU-15=100)	43.1	55.1
Unit labour costs, % yoy	-4.0	8.9

*=averages of the years 2004-2008 & 1999-2003 (exception: exchange rate). ** 2003 vs. 1999 & 2008 vs. 2004

Sources: Eurostat, DB Research 41

Estonia's macroeconomic dataset does, however, clearly highlight the fine line between dynamic expansion and economic overheating. Driven by strong growth in imports, chiefly of consumer goods, the deficit in merchandise trade widened from 12% of GDP in 2002 to as much as 18% in 2007, while during the same period the surplus on trade in services shrank from 10% to 6% of GDP. These negative external trends pushed up the current account deficit from 5.2% in 2001 to more than 18% in 2007. But despite Estonia's external imbalances the country has managed to keep domestic overheating within tolerable limits thanks to a sound fiscal policy with budget surpluses ranging from 0.5% to 3% of GDP between 2002 and 2007. Yet even this conservative course was evidently not restrictive enough, as strong credit growth in the private sector counteracted efforts to redress economic imbalances. From 2004 to 2007 annual credit growth ranged between 30 and 40%, with similarly high rates of expansion prior to EU accession. This jacked up total domestic lending from 34% of GDP in 2000 to 98% in 2008, most of the expansion not being covered by domestic savings. Consequently, external debt also soared between 2000 and 2008, jumping from 45% to 108% of GDP.

It is not therefore particularly surprising that in spite of its fundamental wish to join the euro, Estonia has been far removed in recent years from fulfilling the relevant Maastricht criteria. In the period of correction of its economic imbalances that the country now faces, which we believe will stretch over the next couple of years, the procyclical effect of the currency board will come into play, although the necessary macroeconomic corrections should be more moderate than in Latvia despite the marked increase since 2004 in Estonia's real effective exchange rate and unit labour costs. This is because its effective exchange rate appears less overvalued from a long-term perspective than in the other Baltic countries and necessary real corrections have kicked in considerably earlier.[26] Moreover, Estonia is one of the most innovative economies in the CEEC and among the more innovative within the EU-27. Given successful correction of its economic imbalances and on the strength of its sound fiscal position, Estonia – already being a member of the Exchange Rate Mechanism (ERM II) – could be the first Baltic country to earn admission to the euro area.

[26] When introducing its currency board Estonia deliberately set the exchange rate too low to preserve its international competitiveness. See Böllhof, Uta (2002). 10 Jahre Systemtransformation in den Baltischen Staaten,. p. 125. Freiburg. What is more, the D-Mark and then the euro were immediately chosen as anchor currencies. For a long time the other Baltic countries opted for a basket of currencies with the US dollar or the basket of IMF Special Drawing Rights as its anchor. As a result Latvia and Lithuania suffered a marked deterioration in their international competitiveness on the important European markets when the dollar went through a period of strength at the end of the 1990s.

Core economic indicators

Hungary	1999-2003	2004-2008
GDP growth, % yoy	4.4	3.0
GDP per capita in EUR, PPP	11,444	15,024
Unemployment rate, %	6.1	7.1
Inflation, % yoy	7.8	4.9
Budget deficit, % GDP	-5.7	-6.5
Current account, % GDP	-7.4	-6.2
Government debt, % GDP	56.2	64.0
Foreign debt, % GDP	63.1	90.8
Exchange rate vs. EUR	253.5	254.1

Sources: Eurostat, DB Research 42

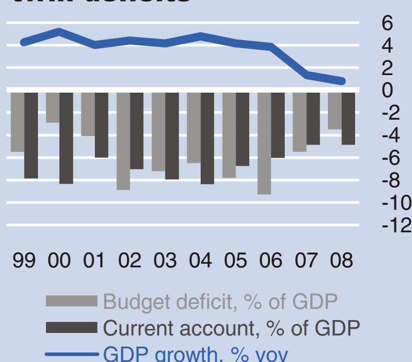
Int. competitiveness*

Hungary	1999-2003	2004-2008
Effective exchange rate, %**	17.0	16.7
Exports in % of GDP	66.6	73.9
Exports, % yoy	12.5	18.8
Labour productivity (EU-15=100)	59.8	65.8
Unit labour costs, % yoy	5.1	4.1

*=averages of the years 2004-2008 & 1999-2003 (exception: exchange rate). ** 2003 vs. 1999 & 2008 vs. 2004

Sources: Eurostat, DB Research 43

HU: Weak growth with twin deficits



Sources: Eurostat, DB Research 44

Hungary (HU)

At the beginning of transition Hungary and Slovenia held pole positions among the CEEC.[27] For a long time Hungary was consequently one of the growth stars and main recipients of FDI.[28] However, between 2004 and 2008 economic growth slowed considerably on the previous period 1999-2003, leaving it languishing in the wake of the other CEEC's post-accession boom. Indeed, since joining Europe, Hungary's economic growth has only been slightly higher than in the EU-15.

For years the public and private sectors lived beyond their means – both before and after EU accession. As a result, Hungary today posts both the highest public debt-to-GDP ratio of the CEEC and the highest external debt of the CEEC-5. And in the period 2000 to 2008 Hungary also reported the highest budget deficit of the CEEC, averaging 6% of GDP and hitting spikes of 9.0 and 9.3% in the parliamentary election years 2002 and 2006. The private sector followed the public sector's lead, as total domestic lending soared between 2000 and 2008 from 54% to 81% of GDP. The increase was especially steep from 2004 to 2008 despite the weakness of the real economy. As a result, Hungary today has the highest stock of credit as a percentage of GDP throughout the CEEC-5 and it registered the fastest expansion in CEEC-5 financial intermediation, alongside Poland – although from much higher levels. Since most of this expansion was not covered by domestic savings, Hungary's external debt during the same period skyrocketed from 63% of GDP to 106% by 2008. Owing to the high level of debt-financed public and private spending, the country has been unable to stabilise inflation in the lower single-digit range since its EU accession, while the current account deficit as a percentage of GDP has remained in the high single figures. The highest domestic interest rates in the EU, resulting from heavy government borrowing requirements and the need to pay a substantial risk premium, have also fuelled foreign currency borrowing.

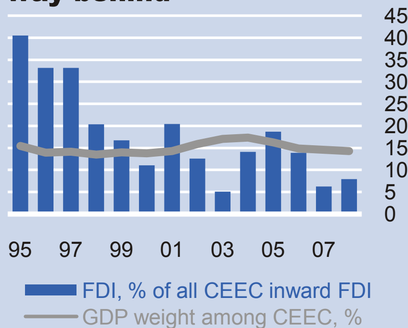
In the fallout from the global financial and economic crisis Hungary thus became the first CEE state to need both liquidity support from the ECB and a hefty emergency loan and stabilisation package worth EUR 20 bn, engineered by the IMF with EU/World Bank participation. But despite structural disadvantages versus the CEEC-5 (such as a lower workforce participation rate and heavier tax burden), Hungary is still surprisingly well ranged for recovery – notably because of its solid international competitiveness. Its labour productivity is the third highest of the CEEC-5 relative to the EU-15, and the real exchange rate of the HUF has risen less steeply in past years than in other CEEC. Unit labour costs have also climbed only moderately since 2004. Hungary has the highest CEEC share of high-tech shipments in total exports and can also hold its own with the Czech Republic and Slovenia on some education and R&D indicators.

Reporting the weakest macroceconomic dataset of the CEEC-5, it i s hardly surprising that for a long time Hungary has failed to meet any of the Maastricht criteria. The strings attached to the IMF pro-

[27] Friedländer, Michael (1988). More austerity and more reform announced in Hungary. In Hubert Gabrisch (Editor). Economic Reforms in Eastern Europe and the Soviet Union, pp. 125-131. Westview Press.

[28] Hungary's performance here was based chiefly on its considerable legal security in respect of joint ventures and ADI. See Pankov, Vladimir. Ökonomie der Reformländer. Service-Fachverlag, pp.164-165.

HU: FDI front runner falls way behind



Sources: EBRD, DB Research **45**

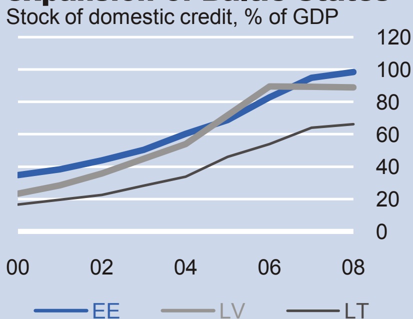
Core economic indicators

Lithuania	1999-2003	2004-2008
GDP growth, % yoy	7.9	4.7
GDP per capita in EUR, PPP	8,356	13,330
Unemployment rate, %	14.5	7.4
Inflation, % yoy	0.5	4.7
Budget deficit, % GDP	-2.3	-1.2
Current account, % GDP	-6.0	-10.3
Government debt, % GDP	22.0	17.8
Foreign debt, % GDP	42.0	65.7
Exchange rate vs. EUR	3.5	3.5

Sources: Eurostat, DB Research **46**

LT: Most moderate credit expansion of Baltic States

Stock of domestic credit, % of GDP



Sources: IMF, DB Research **47**

Int. competitiveness*

Lithuania	1999-2003	2004-2008
Effective exchange rate, %**	13.4	14.0
Exports in % of GDP	36.9	48.3
Exports, % yoy	16.3	26.1
Labour productivity (EU-15=100)	40.8	51.5
Unit labour costs, % yoy	-7.5	-2.8

*=averages of the years 2004-2008 & 1999-2003 (exception: exchange rate). ** 2003 vs. 1999 & 2008 vs. 2004

Sources: Eurostat, DB Research **48**

gramme now aim gradually to ready the country for the euro. If Hungary can successfully implement the adjustments stipulated in the coming year, this could open up the perspective of EMU membership for 2015.

Lithuania (LT)

Since joining the EU the largest of the Baltic economies has posted only moderate rates of growth in comparison to its neighbours – although with less external debt financing than in Estonia and Latvia. The latter was possible due to the lowest rate of expansion in financial intermediation in the region, even though it is still high in absolute terms. The stock of domestic credit climbed “only” from 16% of GDP in 2000 to 66% in 2008. The most moderate increase in household borrowing among the Baltic States was undoubtedly fostered by the central bank’s timely appeal on restraint to the banking sector. Even so, Lithuania’s macroeconomic dataset still bears the marks of external imbalances. There, too, the consumption- and import-driven current account deficit averaged 10% of GDP from 2004 to 2008.

The average GDP growth of a 4.7% from 2004 to 2008 is considerably slower than in the CEEC-5, with the exception of Hungary. This meagre performance – despite starting out from a low base level – points to deeper structural shortcomings. Despite the generally positive business climate parts of the public sector still exhibit structural weaknesses, even after EU accession. Lithuania has consequently failed to attract FDI on a substantial scale for many years, making its FDI stock the lowest of the CEEC. Even today Lithuania’s external openness is therefore relatively low for such a small economy and particularly in the context of the EU.

As it shapes up to a correction of its economic imbalances over the next couple of years, Lithuania will have to contend with the procyclical effect of its currency board. Given its still moderate overall economic expansion in recent years by regional standards, the necessary macroeconomic corrections should be more moderate than for its Baltic neighbours, and its international competitiveness has even improved slightly since joining the EU following a slight drop in unit labour costs. Even so, Lithuania is in a worse structural position than the leading CEEC to swing rapidly onto a sustainable growth path. Together with Latvia, it exhibits the lowest productivity of the CEEC. To make matters worse, Lithuania is an innovation laggard in the group. Although willing to join the euro, its structural weaknesses and economic imbalances clearly render it ineligible and far removed from (sustainable) compliance with the Maastricht criteria. Once economic balance has been restored, Lithuania – which is already a member of ERM II – could be admitted to EMU earliest in 2012.

Latvia (LV)

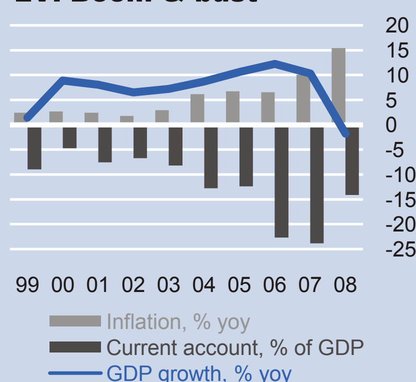
Since joining the EU Latvia has set about overtaking all the CEEC in no time at all, notching up the highest GDP growth rate within that group and in the EU as a whole. But its macroeconomic dataset clearly shows signs of overheating. Latvia’s growth dynamic since EU accession, driven by a drastic hike in the extent of financial intermediation, lifted its external debt up to 139% of GDP in 2008. The volume of domestic lending relative to GDP was boosted between 2000 and 2008 from 23% to 89%, the most rapid expansion of all CEEC corresponding to credit growth of 30-60% p.a. since 2000, with further acceleration since EU accession. Amid

Core economic indicators

Latvia	1999-2003	2004-2008
GDP growth, % yoy	6.4	8.0
GDP per capita in EUR, PPP	7,696	12,419
Unemployment rate, %	12.7	8.0
Inflation, % yoy	2.5	9.0
Budget deficit, % GDP	-2.5	-0.9
Current account, % GDP	-7.2	-17.2
Government debt, % GDP	13.4	12.0
Foreign debt, % GDP	66.3	116.0
Exchange rate vs. EUR	0.6	0.7

Sources: Eurostat, DB Research 49

LV: Boom & bust



Sources: Eurostat, DB Research 50

Int. competitiveness*

Latvia	1999-2003	2004-2008
Effective exchange rate, %**	-7.2	26.0
Exports in % of GDP	38.3	42.6
Exports, % yoy	9.0	25.3
Labour productivity (EU-15=100)	36.7	45.0
Unit labour costs, % yoy	-13.1	17.8

*=averages of the years 2004-2008 & 1999-2003 (exception: exchange rate). ** 2003 vs. 1999 & 2008 vs. 2004

Sources: Eurostat, DB Research 51

the most extreme household lending boom of all the CEEC, trade and current account deficits scaled dizzying heights – and with them inflation. A procyclical fiscal policy added to this overheating. Budget surpluses were non-existent, and 2007 was the only year in which the budget at least broke even.

All in all, external imbalances were built up in Latvia, that the country could no longer cope with. It was therefore forced to seek international support. The IMF, EU and bilateral sponsors from the Nordic states and the CEEC put together a rescue package worth EUR 7.5 bn, equivalent to a massive 30% of Latvia's GDP.[29] It is clear that Latvia must look forward to some tough macroeconomic belt-tightening to correct its imbalances and restore its international competitiveness. Bruising inflation and high pay increases between 2004 and 2008 turned it into the CEE state with by far the steepest increase in unit labour costs, while its productivity relative to the EU-15 is the lowest of all CEEC. Adding insult to injury, Latvia is one of the innovation laggards among the EU-27 and CEEC. This will make rapid return to a sustainable growth path far more difficult than for its Baltic neighbours. Against this backdrop Latvia was obviously way off course in recent years for introduction of the euro. Once it has made the necessary correction to its economic imbalances and completed the ongoing IMF austerity programme, it can entertain the prospect of joining the monetary union.[30]

Poland (PL)

Despite the need to slim down its industrial sector, the most radical reforms to transform Poland into a market economy made it the FDI destination of choice among the CEEC from the outset,[31] and even more so since its macroeconomic stabilisation successes as from the late 1990s. All told, Poland's macroeconomic dataset, along with that of the Czech Republic and Slovenia, is the soundest in the CEEC. Inflation has stabilised in the low single-figure range since 2000 and the central bank has established itself as an independent and credible institution. After Poland joined the EU its budget deficits also shrank and have been compatible in recent years with the Maastricht criteria. As a result the public debt-to-GDP ratio has steadied at a moderate 45%.

The level of financial intermediation has also risen significantly in the past years. Expansion was on a similarly rapid scale to Hungary, although starting out from lower levels. Domestic lending rose between 2000 and 2008 from 34% to 60% of GDP, a rate of expansion that could not always be financed from local savings. This has pushed up Poland's latter-year external debt from 40% to 53% of GDP. On the back of a high interest rate policy driven by the domestic economic dynamic, foreign currency lending has also become widespread. Indeed, Poland experienced strong credit

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[29] The relative size of the international bailout package lead-managed by the IMF is thus comparable in scale only to the rescue programme needed to stabilise Iceland, which was also equivalent to around 30% of the country's GDP; by way of comparison, the aid put together for Hungary amounts to roughly 17% of its GDP.

[30] Under the IMF-led stabilisation programme for Latvia the Fund entertained the option of devaluation or breaking with the pegged exchange rate regime. According to IMF thinking, following devaluation of the national currency Latvia would then have been admitted quickly to the euro area. See IMF (2009). Country Report No. 09/3, Republic of Latvia: Request for Stand-By Arrangement – Staff Report, pp. 26-27. However, both Latvia itself and the EU institutions dismissed this course.

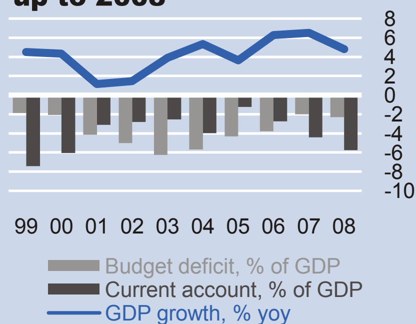
[31] Balcerowicz, Leszek, Barbara Blaszczyk and Marek Dabrowski. The Polish Way to the Market Economy 1989-1995. In Jeffrey D. Sachs (Editor), Economies in Transition, Comparing Asia and Eastern Europe, pp. 131-160. MIT Press.

Core economic indicators

Poland	1999-2003	2004-2008
GDP growth, % yoy	3.1	5.3
GDP per capita in EUR, PPP	9,436	12,506
Unemployment rate, %	17.5	15.1
Inflation, % yoy	5.1	2.7
Budget deficit, % GDP	-3.9	-3.6
Current account, % GDP	-4.4	-3.6
Government debt, % GDP	40.7	46.1
Foreign debt, % GDP	41.9	50.5
Exchange rate vs. EUR	4.1	3.9

Sources: Eurostat, DB Research 52

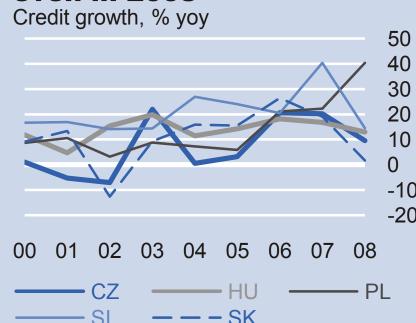
PL: Strong GDP growth up to 2008



Sources: Eurostat, DB Research 53

PL: High credit growth even in 2008

Credit growth, % yoy



Sources: IMF, DB Research 54

Int. competitiveness*

Poland	1999-2003	2004-2008
Effective exchange rate, %**	-3.4	24.9
Exports in % of GDP	27.8	40.0
Exports, % yoy	11.6	25.7
Labour productivity (EU-15=100)	47.7	57.8
Unit labour costs, % yoy	-7.6	1.9

*=averages of the years 2004-2008 & 1999-2003 (exception: exchange rate). ** 2003 vs. 1999 & 2008 vs. 2004

Sources: Eurostat, DB Research 55

growth far into 2008 and was the CEE country with the steepest rise in financial intermediation last year. In 2008 alone the stock of domestic credit as a percentage of GDP jumped 14 percentage points. It took a long time before the global financial and economic crisis and severe slowdown in European business activity worked its way through to Poland.

Given the solid macroeconomic environment, it is hardly surprising that Poland has appreciably stepped up its efforts to join the euro area amid the ongoing financial and economic upheaval. This is chiefly because the strong depreciation of the zloty versus the euro up until recently makes accession to ERM II an attractive prospect and the country has swung round again since 2007 to a clear political preference for strengthening Poland's European role. Considering its monetary and fiscal stability focus, joining the euro area – for which it would first have to sign up to ERM II – would be a logical and feasible step. However, it must be borne in mind that Poland's present level of economic development falls well short of the euro area average. Rapid introduction of the euro would make it the EMU member with the lowest prosperity and price levels ever at the time of accession.

The picture is mixed on Poland's long-range economic perspectives in Central and Eastern Europe. Its absolute market size makes it very interesting for investors wishing to service that market. However, Poland is the least productive of the CEEC-5 relative to the EU-15. Although unit labour costs there have climbed only moderately in recent years, they have nevertheless accelerated more rapidly than in the Czech Republic, Slovakia and Slovenia. Poland is also one of the innovation laggards in the EU-27 and among the CEEC. R&D expenditure is low and private sector commitment in this area below average.

Slovenia (SI)

Slovenia neatly illustrates that there is no set blueprint for CEEC transition. For years it has pursued a path of gradualism on market-based reform. As a result, and despite a high baseline level in the EBRD's aggregated reform index, Slovenia is today the country with the lowest reading in this segment. But its high level of prosperity at the beginning of transition, the plausible EU perspective and early access to the internal market enabled the small country to adopt such a stepwise approach to reform without any substantial foreign financial involvement. Having attracted relatively little FDI for years, Slovenia is today markedly under-represented in the stock of FDI in the region.

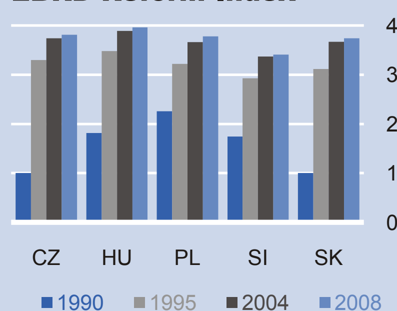
Its gentle transition has enjoyed the benefit of high macroeconomic stability. Since the mid-1990s Slovenia has boasted by far the soundest set of economic data among the CEEC. In spite of a distinct growth differential to the EU-15, inflation has stabilised in the very low single-figure region. Even before EU accession its budget deficits had narrowed considerably, stabilising public debt at a very low level in comparison to the EU-15 countries and the CEEC-5. Slovenia also experienced pronounced expansion in the level of financial intermediation. Domestic lending as a percentage of GDP shot up between 2000 and 2008 from 43% to 66% of GDP. But this still puts financial intermediation well below the level in the Baltic States or Hungary. Rapid introduction of the euro as planned in 2007 has, moreover, minimised the risks attendant on raising external debt. In view of Slovenia's sound economic development and close integration with the euro area economies, accession to

Core economic indicators

Slovenia	1999-2003	2004-2008
GDP growth, % yoy	3.8	4.9
GDP per capita in EUR, PPP	15,838	21,170
Unemployment rate, %	6.6	5.9
Inflation, % yoy	7.4	3.2
Budget deficit, % GDP	-3.2	-1.2
Current account, % GDP	-1.1	-3.1
Government debt, % GDP	27.2	26.0
Foreign debt, % GDP	17.5	22.4
Exchange rate vs. EUR	219.1	144.2

Sources: Eurostat, DB Research 56

SI: Lagging all CEEC-5 in EBRD Reform Index



The scale ranges from 1 to 4.0. A value of 4.0 stands for the successful transition to a fully functioning free market economy as defined in the index categories.

Sources: EBRD, DB Research 57

Int. competitiveness*

Slovenia	1999-2003	2004-2008
Effective exchange rate, %**	1.9	4.0
Exports in % of GDP	54.0	67.0
Exports, % yoy	7.6	21.3
Labour productivity (EU-15=100)	68.6	75.9
Unit labour costs, % yoy	0.4	-0.6

*=averages of the years 2004-2008 & 1999-2003 (exception: exchange rate). ** 2003 vs. 1999 & 2008 vs. 2004

Sources: Eurostat, DB Research 58

that currency area has clearly proved a logical step. As the global financial and economic crisis unfolds, the country has benefited substantially from membership of the big hard-currency bloc.

With regard to its future economic development, we consider Slovenia well positioned structurally. Its economy is among the more innovative in the EU-27 and the most innovative of the CEEC. High-tech exports account for a large share of total shipments – fostered without doubt by the private sector's substantial contribution to R&D spending. In the long term, though, Slovenia will be hardest hit by the negative demographic trend in the CEEC; on the basis of current projections it will have to bear considerably higher pension costs than the EU-15 countries, and great effort will be needed in this respect to maintain its present economic position.

Slovakia (SK)

The late starter of the CEEC-5, Slovakia subsequently caught up rapidly in the EU accession process. Until the end of the 1990s foreign investors showed very little interest in the country owing to its political isolation. Relative to its economic weight, Slovakia was clearly under-represented in FDI inflows into the region. But then in 2000 it launched a drastic programme of reform to tap its existing economic potential and ensure that it was on track for the EU's 2004 round of enlargement. Since then it has attracted substantial amounts of FDI and consequently captured a disproportionately large chunk of the direct investments flowing into the CEEC from abroad. In some years the country has garnered roughly as much or more FDI than far-larger Poland. Today Slovakia is the CEE economy most closely integrated into the EU, with intra-EU trade accounting for 87% of its total trade.

Slovakia's macroeconomic dataset reflects its remarkable race to catch up. During the period 2004-2008 Slovakia experienced the biggest post-accession boom of the CEEC-5 in terms of average GDP growth. Even so, according to the ECB convergence report it expanded far less above potential than, say, the Baltic countries, enabling it to retain its international competitiveness over the years. Even in the boom phase from 2004 to 2008 unit labour costs in Slovakia rose only marginally. Slovakia is one of the CEEC with the highest productivity.

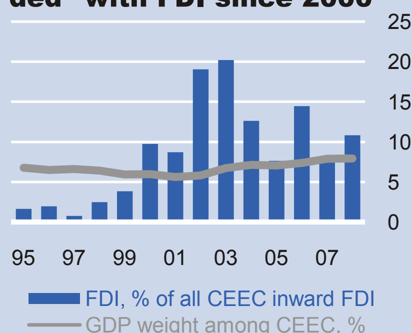
Considering that its reform momentum was late taking off, its macro-economic stabilisation slow to materialise and its subsequent race to catch up headlong, Slovakia clearly made a precision landing as far as the Maastricht criteria were concerned. In the throes of the global financial and economic crisis the country has benefited from its secure position in the EU's hard currency bloc since mid-2008 and subsequent EMU accession in January 2009. But its notable latter-year performance does not mean the challenges facing it in the coming years have grown any less. As an EMU member, the marked increases it has seen in its real effective exchange rate in the past years now call for very sound wage and fiscal policies to maintain its high level of industrialisation and keep a lid on the current account deficit. In Slovakia, too, this was bloated in recent years by a powerful – and, indeed, partly credit-financed – expansion in domestic demand. What is more, in comparison to the leading CEEC, the Czech Republic and Slovenia, Slovakia still has plenty of ground to make good in respect of R&D and innovative capacity indicators.

Core economic indicators

Slovakia	1999-2003	2004-2008
GDP growth, % yoy	2.9	7.5
GDP per capita in EUR, PPP	10,294	15,094
Unemployment rate, %	18.2	14.8
Inflation, % yoy	8.3	4.4
Budget deficit, % GDP	-7.1	-3.1
Current account, % GDP	-4.5	-6.8
Government debt, % GDP	46.6	33.5
Foreign debt, % GDP	53.4	56.7
Exchange rate vs. EUR	42.4	35.0

Sources: Eurostat, DB Research 59

SK: Reform star "rewarded" with FDI since 2000



Sources: EBRD, DB Research 60

Int. competitiveness*

Slovakia	1999-2003	2004-2008
Effective exchange rate, %**	26.3	43.5
Exports in % of GDP	68.8	79.7
Exports, % yoy	18.7	25.7
Labour productivity (EU-15=100)	53.4	64.9
Unit labour costs, % yoy	-2.8	0.3

*=averages of the years 2004-2008 & 1999-2003 (exception: exchange rate). ** 2003 vs. 1999 & 2008 vs. 2004

Sources: Eurostat, DB Research 61

Introduction of the euro in the CEEC

The repercussions of the global economic and financial crisis are most evident in the issue of accession to the European Monetary Union (EMU), leading to resurgence across Central and Eastern Europe in the original eagerness to adopt the euro as the common currency. During the EU accession process all CEEC had already set ambitious targets for introduction of the euro, but the aspirations of most faded as it emerged during their ongoing transformation just how difficult fulfilment of the Maastricht criteria was. However, politicians in some CEEC countries did display a rather laid-back attitude towards their contractual commitments to Europe, which stipulate that all EU Member States must pursue a sustainable stability policy leading to compliance with the Maastricht criteria and hence introduction of the euro.[32] It is therefore not surprising that only last year Eurobarometer found that 65% of the population in the CEEC were convinced they were at liberty to decide whether they wished to join EMU or not.[33] From an economic viewpoint this reluctance to adopt the euro by some CEEC that would actually be eligible to do so is surprising. Their close integration into the internal market means EMU membership would in principle have positive economic effects. For most CEEC the euro area is by far the biggest trade partner, while some also still have strong trade relations with one another.[34] In addition to aspects such as trade creation and lower transaction costs, the impact on competitiveness of not signing up to the euro should not be underestimated – hence the growing calls from the private sector in some CEEC to speed up EMU accession. The influence being brought to bear by some CEE corporate sectors in particular to expedite introduction of the common currency (for example through their locational policies, opening production sites in the CEEC already in the euro area) could intensify if some CEEC joined EMU in the coming years and others did not. Nor should political pressure for fast introduction of the euro in the CEEC be underestimated since the European currency is already widely used and many households evidently expect EMU membership in the near future.

[32] The UK and Denmark were alone in negotiating opt-out clauses relieving them of the obligation to join EMU.
[33] Introduction of the euro in the new Member States. Eurobarometer 2008.
[34] Were Sweden possibly to join EMU the euro area would also be the major trade partner for all the Baltic States.

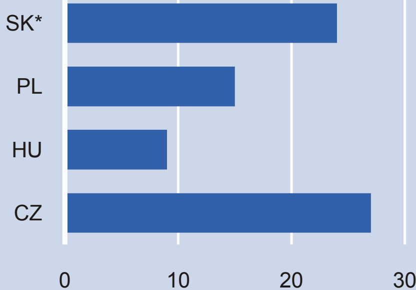
Euro introduction target dates at 2004 EU enlargement

Estonia	2007
Lithuania	2007
Latvia	2007
Czech Republic	2009/2010
Hungary	2008
Poland	2007/2008
Slovenia	2007
Slovakia	2008/2009

Sources: Historical documents from national central banks, DB Research **62**

High de facto euroisation

Share of population with euro cash holdings, % (2008)

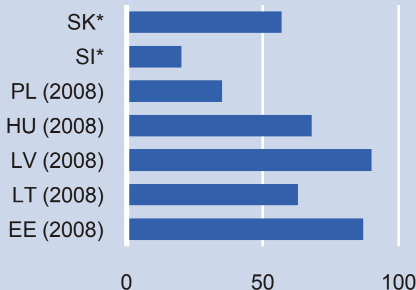


*Slovakia prior to EMU accession

Source: OeNB Euro Survey in Central, Eastern and Southeastern Europe 2008 **63**

Foreign currency loans in the CEEC

% of total lending



*In the last year before euro introduction

Sources: National central banks, DB Research **64**

No rush into EMU in spite of crisis

Whereas it has so far been more a matter of persuading the CEEC to join the euro (with the exception of Slovenia and Slovakia, which already belong), in the wake of the economic and financial upheaval there has now been a shift in focus towards heading off a rush into EMU without the proper economic credentials. The current situation has brought to a head the recent controversy over whether admission of the new EU states to Europe's currency club permits, or indeed necessitates, modification of the convergence criteria on low inflation, interest rate convergence, budget discipline and exchange rate stability. Although equal treatment of the candidate countries is politically advisable, if experience with ten years of the euro were to reveal the need for improvement, the issue should be discussed openly.

Debate centres on the inflation and exchange rate criterion. With regard to the former it is rightly argued that for its relative definition the three EU countries with the lowest inflation do not even need to be EMU members and the average of the top three is systematically lower today than it was ten years ago. It would therefore be worth considering using the ECB's definition of price stability, as the established euro area benchmark.[35] To ensure that the reference value is still compatible with price stability, it could be defined as close to 2% with a margin of one percentage point. However, any political agreement on this should not culminate in formal treaty amendments, which would again be subject to ratification, but should take another form. As for the exchange rate criterion, which stipulates tension-free participation in ERM II for at least two years, there are some calls to limit this period – particularly in the light of the financial crisis – to enable a "short cut" to EMU. Among other things, participation in ERM II is intended to reflect whether the EMU aspirants are capable of cushioning different productivity trends even without devaluations and are pursuing a stability-oriented policy.

Recent thinking by the IMF goes well beyond the debate on modification of the Maastricht criteria. According to newspaper reports the Fund proposes that the CEEC scrap their currencies for the euro. [36] But this unilateral euroisation would not confer representation in the ECB bodies, unlike the 16 official EMU members, or give the "gatecrashers" a say in monetary policy decisions. Besides leaving open technical euroisation issues, such as the exchange rate at which conversion of the national currencies into the euro is supposed to take place, the proposal does not take adequate account of institutional aspects. It is difficult to conceive of countries surrendering national competence for monetary and exchange rate policy without being given a say in European decisions in return. The unanimous rejection of unilateral euroisation by the EMU members, EU institutions and the ECB is therefore perfectly warranted and makes the likelihood of this proposal being realised rather slim.[37] The EU institutions have made it clear on several occasions that Montenegro and Kosovo must be seen as very special cases; nor would unilateral euroisation be feasible for

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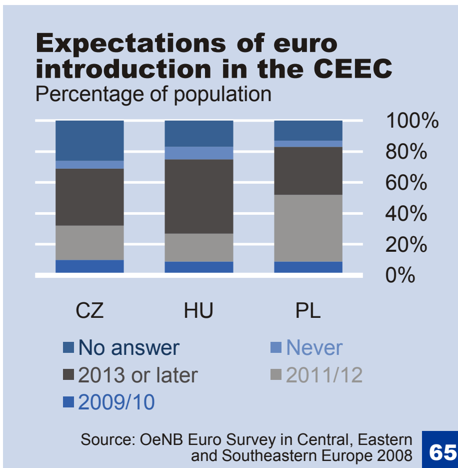
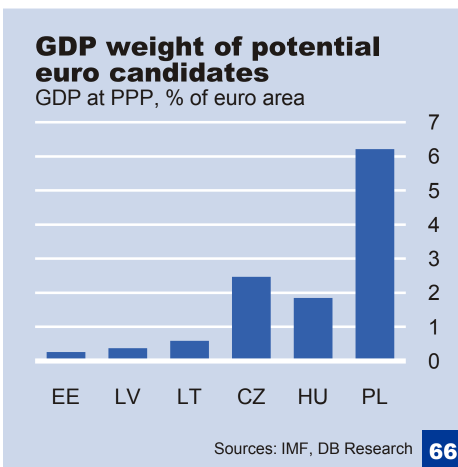
[35] For a discussion on modification of the convergence criteria see Becker, Werner (2008). The euro turns ten. DB Research. EU Monitor 57. Frankfurt am Main.

[36] FT, April 6, 2009.

[37] See also Stark, Jürgen (2009). The adoption of the euro: principles, procedures and criteria. Reykjavik. February 13, 2009.





the larger CEE economies – particularly without the support of EU institutions.

EMU as a safe haven

For some CEEC, euroisation and, even more so, rapid formal introduction of the euro would certainly bring advantages, given the current issues with financial system stability. The problematically high volume of foreign currency lending for what is mostly long-term financing would be technically resolved.[38] Consequently the private sector would no longer be vulnerable to severe currency fluctuations. Moreover, most CEE governments could then raise funds in a liquid financial market at lower interest rates than are now available to them – in what would then be their own currency. For non-members of ERM II with floating currencies, simply joining this mechanism could act as a stabilising factor. The goal of full integration into the euro area can also act as an important reform accelerator for the CEEC, with Slovakia as a case in point. But for all the potential benefits of rapid euro introduction or even euroisation in the CEEC, the reservations already discussed apply. The structural problems underlying these countries' external imbalances would weigh far more heavily on them in EMU.

All considerations regarding EMU expansion should always be guided by the fact that giving precedence to speed over thorough economic preparation is in the best interests of neither the EMU candidates nor the monetary union itself. In so far, other mechanisms – some of which have already been used – should be employed for the legitimate concerns of financial system stabilisation in some CEEC.[39]

Euro area enlargement scenario

Central pillars of EMU eastward enlargement…

Generally speaking, following introduction of the euro in Slovenia and even more so in Slovakia (which most CEEC see as a more direct standard of comparison) and also as a result of the financial and economic crisis, all the CEEC have become considerably more inclined to adopt the euro. The outlook for continuation of eastward EMU enlargement is thus good, and our enlargement scenario builds on the constancy of all the CEEC's willingness to join the euro area. Furthermore, the signs of correction in the domestic and external imbalances created by the post-EU-accession boom in some CEEC increase their chances of meeting the nominal Maastricht criteria within a time frame of one to three years. This applies primarily to the nominal inflation criterion, hitherto the main stumbling block for most CEE aspirants – all the more so since another credit boom appears unlikely in these CEEC in the run-up to euro adoption, in view of the strong credit expansion they have already experienced and the changing conditions in international capital markets.

… willingness to join and lessening economic imbalances

Baltic States possibly eligible for euro membership from 2012

Before we go into greater detail on our scenario for accession of the CEEC to the euro area the following should be noted. All accession dates mentioned refer to accession effective on January 1 of the year stated (i.e. accession in 2012 stands for introduction of the

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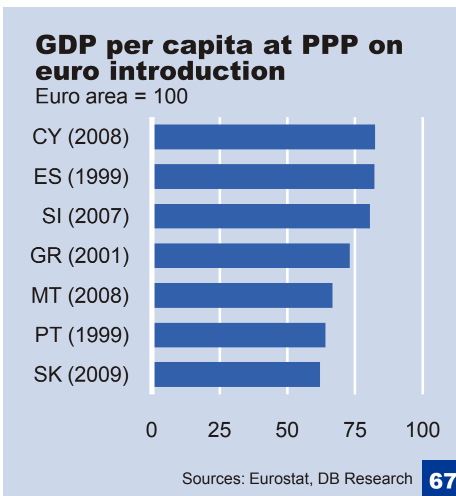
[38] The risks involved in Swiss franc loans (these loans are common in Poland) would not be eliminated entirely, since the exchange rate of the euro can also fluctuate strongly against the Swiss franc. As a rule, though, these fluctuations are far less pronounced than the fluctuations in the freely convertible CEE currencies at the same point in time.

[39] Possibilities here are liquidity support by the ECB or EU participation in IMF financial assistance.

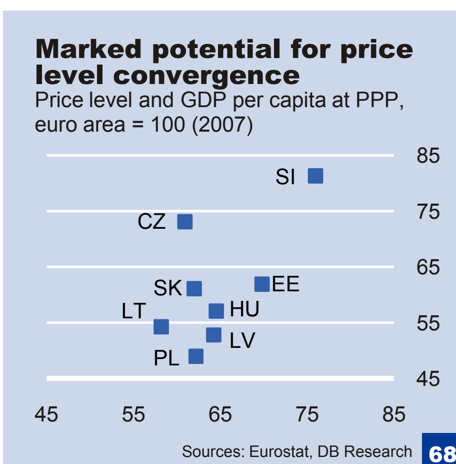


euro on January 1, 2012). It is thus clear that we consider continuation of the practice so far of enlarging EMU at the turn of the year to be the most realistic scenario.

If the economic imbalances in the aspirant Baltic States are corrected following swingeing reforms, we consider 2011 the earliest possible date for their accession to EMU, with Estonia as the most likely candidate here. But even for the three countries that have belonged to ERM II for many years, this date appears extremely ambitious since it would imply the ECB and the other relevant EU institutions declaring them ready for accession in the first half of 2010. Given the substantial real adjustments necessary for this and the associated macroeconomic volatility, we do not consider this realistic. 2012 therefore appears a more likely date (subject to a successful convergence review in 2011 based on the Maastricht criteria) for the earliest accession to the euro area by the first Baltic States.

CZ, PL and HU: Accession in 2013 possible in principle

Far greater EMU enlargement – in terms of the accession countries' economic weight – could then follow from 2013 with the Czech Republic, Hungary and Poland, at least technically from the perspective of the Maastricht criteria. But again, this timeline is ambitious and should be seen as the earliest possible option, particularly for Hungary. To join the euro area in 2013 the trio would definitely have to sign up to ERM II in the first half of 2010, which presupposes only a two-year membership (the statutory minimum). We do not necessarily consider such a scenario realistic. Amid the current volatility in the freely convertible CEEC currencies (some of which is well in excess of the ERM II +/- 15% fluctuation band) and some still substantial deviations in the real exchange rates from their long-term averages, rapid ERM II membership could prove quite problematic. Apart from the need to solve the parity issue, hefty interventions on the foreign exchange market could later be required. It is true that so far all ERM II memberships of CEEC with flexible exchange rates have gone smoothly. However, unlike the CEE currencies now under consideration, the Slovenian tolar and the Slovak koruna were not internationally traded currencies with developed (derivative) foreign exchange and fixed income markets, making speculative activity more difficult. Nor did either country stray from a credible path of compliance with the Maastricht criteria and the prospect of rapid membership of the euro area during its ERM II membership.



Particularly for countries with internationally traded currencies such as Poland, the Czech Republic and Hungary, membership of ERM II should not therefore be conferred until a broad political basis is in place, consisting of willingness to adopt the euro and a credible perspective for medium-term and sustainable compliance with the Maastricht criteria.[40] Over-hasty membership of ERM II could even be to these CEEC's disadvantage in the long term: Both a parity chosen in the near future and the final exchange rate relative to this could turn out to be much lower than needed in the long term to contain probable increases in inflation. We believe namely that the European institutions will not depart all that much from their practice

[40] Successful introduction of the euro in Slovakia and Slovenia marked the culmination of a long-term process, based on comprehensive planning and broad political consensus on the fundamental benefits, to ensure that the eligibility and willingness to sign up to the euro area coincided at a scheduled point in time. A euro strategy was devised for Slovakia in 2003 and it joined ERM II in 2005; despite the change of government in 2006 it kept its sights set on introduction of the euro in 2008 or 2009 and ultimately joined the euro club on January 1, 2009.

High international trading volumes in CZK, HUF & PLN

		Daily trading turnover	Av. trading size
		Mrd. USD	USD m
Czech Rep.	CZK	1.3	20
Hungary	HUF	1.5	20
Poland	PLN	3	30
Brazil	BRL	2	5
South Africa	ZAR	3.5	20
South Korea	KRW	6.8	10
Turkey	TRY	2	10

Sources: IMF, DB Global Market Research 69

so far, i.e. by not choosing a parity too far removed from market levels and, with membership of ERM II lasting only a few years, favouring no more than two parity adjustments on the strong side of the standard fluctuation band.

Moreover, the CEEC should bear in mind that ERM II membership can certainly last longer (as was the case with Slovakia) than the minimum two-year period prescribed, in order to achieve sustained compliance with the Maastricht criteria. In the light of this we view 2014 or even 2015 (particularly in the case of Hungary, which is not yet fit for accession) as realistic euro introduction dates in the big three CEEC.

EMU enlargement scenario

Earliest possible date for euro introduction		Necessary convergence report	Necessary ERM II membership*
2011	EE	H1 2010	Already a member of ERM II
2012	LT	H1 2011	Already a member of ERM II
	LV		Already a member of ERM II
2013	CZ	H1 2012	ERM II accession in H1 2010
	PL		ERM II accession in H1 2010
	HU		ERM II accession in H1 2011

* Assuming a minimum membership period of 2 years before convergence report

Source: DB Research 70

Barbara Böttcher (+49 69 910-31787, barbara.boettcher@db.com)
Gunter Deuber (+49 69 910-31718, gunter.deuber@db.com)

Maastricht convergence criteria

Price stability (inflation measured by HCPI)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Maastricht limit	**2.0**	**2.6**	**3.0**	**2.5**	**2.5**	**2.2**	**2.5**	**2.9**	**2.8**	**4.1**
EE	3.1	3.9	5.6	3.6	1.4	3	4.1	4.4	6.7	10.6
LT	1.5	1.1	1.6	0.3	-1.1	1.2	2.7	3.8	5.8	11.1
LV	2.1	2.6	2.5	2	2.9	6.2	6.9	6.6	10.1	15.3
CZ	1.8	3.9	4.5	1.4	-0.1	2.6	1.6	2.1	3	6.3
HU	10	10	9.1	5.2	4.7	6.8	3.5	4	7.9	6
PL	7.2	10.1	5.3	1.9	0.7	3.6	2.2	1.3	2.6	4.2
SI	6.1	8.9	8.6	7.5	5.7	3.7	2.5	2.5	3.8	5.5
SK	10.4	12.2	7.2	3.5	8.4	7.5	2.8	4.3	1.9	3.9

Public finances (budget deficit as % of GDP)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Maastricht limit	**-3.0**	**-3.0**	**-3.0**	**-3.0**	**-3.0**	**-3.0**	**-3.0**	**-3.0**	**-3.0**	**-3.0**
EE	-3.5	-0.2	-0.1	0.4	1.8	1.6	1.8	3.4	2.8	-3.0
LT	-2.8	-3.2	-3.6	-1.9	-1.3	-1.5	-0.5	-0.5	-1.2	-1.7
LV	-3.9	-2.8	-2.1	-2.3	-1.6	-1.0	-0.4	-0.2	0.0	-1.1
CZ	-3.7	-3.7	-5.7	-6.8	-6.6	-3.0	-3.6	-2.7	-1.6	-1.4
HU	-5.4	-2.9	-4.0	-8.9	-7.2	-6.5	-7.8	-9.2	-5.5	-4.0
PL	-2.3	-3.0	-5.1	-5.0	-6.3	-5.7	-4.3	-3.8	-2.0	-2.3
SI	-2.0	-3.9	-4.3	-2.7	-2.8	-2.3	-1.8	-1.2	-0.1	-0.9
SK	-7.1	-12.2	-6.5	-8.2	-2.7	-2.4	-2.8	-3.6	-2.2	-2.0

Public finances (government debt as % of GDP)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Maastricht limit	**60.0**	**60.0**	**60.0**	**60.0**	**60.0**	**60.0**	**60.0**	**60.0**	**60.0**	**60.0**
EE	6.0	5.2	4.8	5.6	5.5	5.1	4.5	4.2	3.4	4.3
LT	22.8	23.7	23.1	22.4	21.2	19.4	18.6	18.2	17.3	18.8
LV	12.5	12.3	14.0	13.5	14.6	14.9	12.4	10.7	9.7	12.1
CZ	16.4	18.5	25.1	28.5	30.1	30.4	29.7	29.4	28.7	29.2
HU	59.5	54.3	52.1	55.7	58.0	59.4	61.6	65.6	66.0	67.4
PL	39.6	36.8	37.6	42.2	47.1	45.7	47.1	47.6	45.2	44.8
SI	24.6	27.6	28.3	29.7	29.1	29.5	29.1	27.2	24.1	23.6
SK	47.9	50.4	49.0	43.4	42.4	41.4	34.2	30.4	29.4	32.0

Exchange rate development (vs EUR, % yoy)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Maastricht limit	**+/-15%**	**+/-15%**	**+/-15%**	**+/-15%**	**+/-15%**	**+/-15%**	**+/-15%**	**+/-15%**	**+/-15%**	**+/-15%**
EE	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
LT	-14.84	-7.32	-5.37	-2.00	0.00	0.01	0.00	0.00	0.00	0.00
LV	-11.80	-1.99	-3.49	10.37	9.53	3.78	-0.24	0.14	-0.11	1.71
CZ	2.84	-2.92	-8.80	-1.20	2.64	-6.00	-4.81	-5.22	-3.12	0.93
HU	1.28	4.04	-7.48	-3.63	11.09	-6.30	2.81	-0.44	0.78	5.11
PL	2.15	-7.43	-9.21	15.04	16.93	-13.13	-5.50	-0.75	-6.20	15.58
SI	5.22	7.36	2.48	5.17	2.84	1.29	-0.11	0.06	0.00	0.00
SK	-1.37	3.61	-2.62	-2.99	-0.80	-5.89	-2.23	-9.09	-2.47	-10.29

A negative reading implies appreciation of the national currency versus the euro

Long-term bond yields

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Maastricht limit	6.6	7.3	6.9	6.8	6.1	5.5	5.4	5.7	6.0	6.0
EE	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
LT	n.a.	n.a.	n.a.	5.97	5.22	4.43	3.73	4.00	4.58	5.61
LV	n.a.	n.a.	n.a.	n.a.	n.a.	4.85	3.53	4.16	5.63	6.71
CZ	n.a.	6.94	6.31	4.87	n.a.	n.a.	3.54	3.80	4.30	4.63
HU	9.91	8.55	7.94	7.09	6.83	8.19	6.6	7.12	6.74	8.24
PL	9.53	11.79	10.68	7.32	5.78	6.92	5.23	5.26	5.5	6.09
SI	n.a.	n.a.	n.a.	n.a.	n.a.	2.49	3.81	3.9	4.54	4.67
SK	n.a.	8.33	8.05	6.91	4.99	5.02	3.52	4.42	4.49	4.72

Sources: DB Research, Eurostat, ECB 71

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