

Box I

THE ECONOMIC RECOVERY IN THE CENTRAL AND EASTERN EUROPEAN EU COUNTRIES

Following the recession in 2008-09, the economies of the eight EU countries in central and eastern Europe outside the euro area (CEE) are recovering gradually, albeit with significant differences across countries.¹ The expansion in economic activity is currently being driven primarily by exports as domestic demand remains subdued. Those countries that accumulated relatively more substantial internal and external imbalances before the financial crisis suffered more severe contractions in output during the crisis, and most of them face a more sluggish economic recovery.

Recent recovery in economic activity

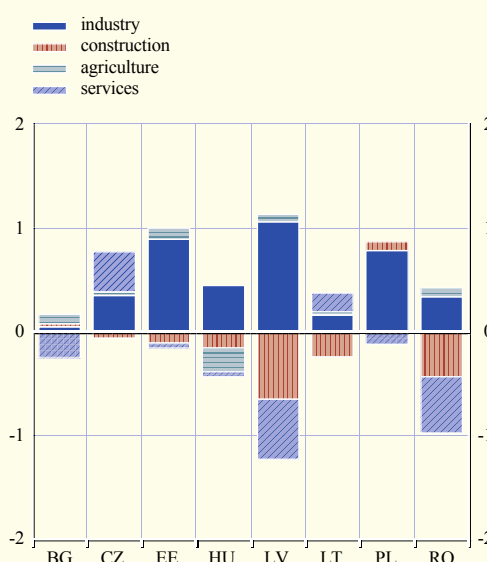
The CEE countries are now edging out of the deepest recession they have experienced since the transition to market-oriented economies, with almost all countries having recorded on average positive quarter-on-quarter GDP growth rates since the second half of 2009. However, the timing and strength of the economic recovery have been heterogeneous across countries. While the upward trend in Poland, the Czech Republic and Estonia started earlier and has been stronger, the recovery in Hungary, Latvia and Lithuania, and in particular in Bulgaria and Romania, did not start until the first half of 2010 and has remained weaker.

In terms of sectoral contributions, the recovery in most CEE countries has been driven by buoyant industrial activity (see Chart A). Conversely, muted construction activity has constrained the recovery in nearly all CEE countries over the past year. This is particularly the case in the Baltic States, where the construction sector expanded at an unsustainable rate during the previous boom period. However, the positive contributions to growth from the construction sector in several countries in the second quarter of 2010 suggest that the downward trend has bottomed out. Similarly, the services sector remained fairly weak at the beginning of the recovery, but, in many countries, it contributed to growth again in the first half of 2010.

The pick-up in economic activity in most countries has been driven mainly by inventories and foreign demand on the back of a rebound

Chart A Sectoral contributions to value added growth

(percentage changes; percentage points)

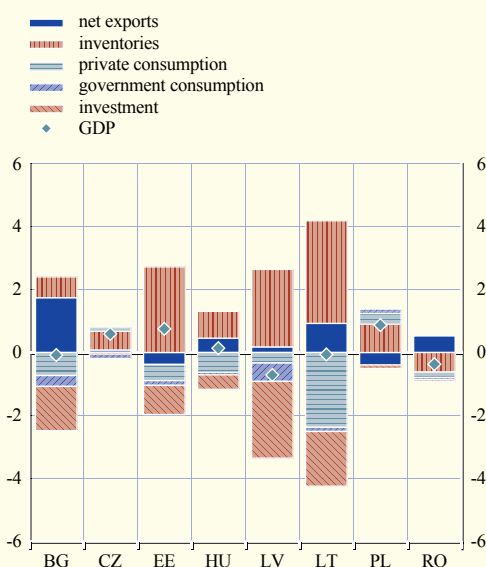


Source: Eurostat.
Notes: Average quarter-on-quarter growth rates over the period from the third quarter of 2009 to the second quarter of 2010. Data are working day and seasonally adjusted except for Romania (only seasonally adjusted).

¹ For a more detailed analysis of economic developments in the CEE countries before and during the crisis, see the article entitled “The impact of the financial crisis on the central and eastern European countries”, *Monthly Bulletin*, ECB, July 2010.

Chart B Contribution of expenditure to real GDP growth

(percentage changes; percentage points)



Source: Eurostat.

Notes: Average quarter-on-quarter growth rates over the period from the third quarter of 2009 to the second quarter of 2010. Data are working day and seasonally adjusted except for Romania (only seasonally adjusted).

in world trade since the second half of 2009 (see Chart B). By contrast, domestic demand has remained subdued in all countries except Poland. Private consumption has receded further in Bulgaria and Hungary, and especially in the Baltic States, where private consumption had risen considerably before the crisis and unemployment has reached high levels (around 18.5% in the second quarter of 2010). Likewise, investment has not yet started to recover since the end of the recession. In fact, it decreased further in all CEE countries in the first half of 2010. Government consumption has also made a negative contribution to economic growth in the region, reflecting already stretched public finances and fiscal consolidation efforts. Weighted average public deficits were around 6.7% of GDP in 2009 and are projected by the European Commission to remain broadly unchanged in 2010.

domestic demand. Credit growth to the private sector in the region has fallen gradually from the unsustainably high levels it reached in 2007-08, bottoming out at single-digit growth rates during the first half of 2010. The Baltic States and Hungary have even experienced negative credit growth rates since the second half of 2009, reflecting a reduced level of private sector indebtedness. Although this is helping to repair households' balance sheets, it is hampering private consumption in the short term. In addition, the high ratio of non-performing loans in some countries (between 17.5% and 19.2% in Lithuania, Latvia and Romania in the first quarter of 2010) is limiting banks' scope for further lending.

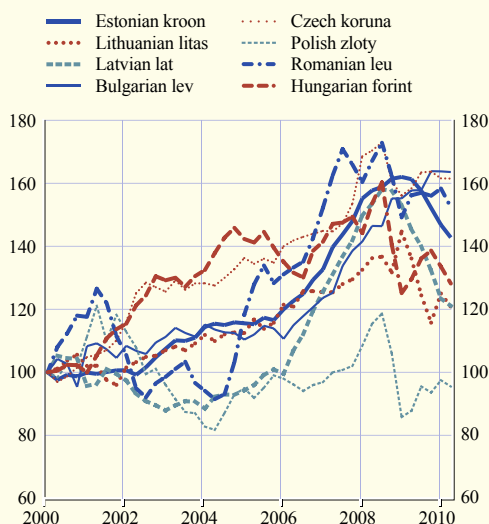
Macroeconomic imbalances, which had been built up in some CEE countries prior to the crisis, are gradually being reduced. This process is necessary, but is currently constraining

Alongside the slowdown in credit growth, financial account balances have deteriorated further since the onset of the recovery, compared with the levels seen during the crisis, and considerably more compared with the previous boom period. Turning to the individual types of capital flow, portfolio inflows, which tend to be a relatively volatile form of capital inflow, became negative in a number of CEE countries during the crisis. More recently, however, this downward trend has reversed in some countries (e.g. Lithuania and Poland). By contrast, most of the CEE countries continued to attract foreign direct investment (FDI) or recorded only small outflows during the crisis and the ongoing recovery period. These FDI inflows are likely to play an important role in supporting sustainable economic growth, especially if they are directed to the tradable sector.

Prior to the crisis, imbalances emerged in many CEE countries, among other things, as a result of unsustainable increases in employee compensation, which significantly exceeded productivity gains. During the crisis, however, some of the countries reduced nominal wages, in particular the Baltic States, where they have dropped by 26% on average since the middle of 2008. Although

Chart C Real effective exchange rates based on unit labour costs

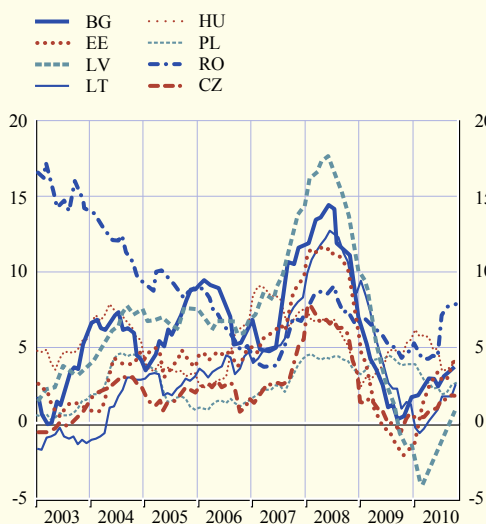
(Q1 2000 = 100)



Source: ECB calculations.

Chart D HICP inflation

(annual percentage changes; monthly data)



Source: Eurostat.

this drop in disposable income is an additional burden on households' ability to consume, the adjustments have helped these CEE countries to partly compensate for the earlier loss of price competitiveness vis-à-vis their main trading partners (see Chart C). The CEE countries with a flexible exchange rate regime (i.e. Hungary, the Czech Republic, Poland and Romania) enhanced their competitiveness mainly through a sizeable nominal depreciation of their currencies in 2008 and early 2009, although these developments were partly offset by appreciations at the end of 2009 and early 2010. Altogether, the rebound in foreign demand, greater competitiveness and subdued domestic demand have led to a sharp decline in current account deficits in the CEE countries. In the case of the Baltic States and Hungary, the deficits even turned into a surplus in the first half of 2010.

Following substantial disinflation (and partly deflation) during the crisis, HICP inflation in the CEE countries with a fixed exchange rate regime (i.e. the Baltic States and Bulgaria) has been rising again since spring 2010 (in Latvia only since September 2010). By contrast, the CEE countries with a flexible exchange rate regime did not experience such high inflation rates during the previous boom period and did not see an equally pronounced phase of disinflation during the crisis (see Chart D). During most of the recovery period to date, inflation rates in these countries have remained positive and below 5%. In Romania, however, inflation has increased further in recent months.

Outlook for economic activity

Looking ahead, economic sentiment surveys signal a further strengthening of the recovery in all CEE countries, albeit to a lesser extent in Bulgaria and Romania. Domestic demand is expected to make a stronger contribution to growth in 2011, although exports are likely to remain a driver of economic activity in the region. With both domestic and

foreign demand expected to gain momentum again next year, projections for real GDP growth in 2011 stand at around 3.5% for the Baltic States and Poland, 2.3% for the Czech Republic, Hungary and Bulgaria, and 1.5% for Romania (see the table). Nevertheless, there are still risks to this outlook. Although the unemployment rate in all CEE countries (except Lithuania) has been decreasing gradually (or at least has stopped rising) since the beginning of 2010, the continued high level of unemployment is likely to dampen private consumption for a prolonged period. Similarly, should the deleveraging of the private sector continue, it will reduce growth in domestic demand. Moreover, additional uncertainties stem from the outlook for external demand as well as capital flows to the region.

GDP forecasts for 2011

(annual percentage changes)

	IMF	European Commission	Consensus Economics
BG	2.0	2.6	2.4
CZ	2.2	2.3	2.2
EE	3.5	4.4	3.8
HU	2.0	2.8	2.4
LV	3.3	3.3	2.9
LT	3.1	2.8	2.9
PL	3.7	3.9	3.8
RO	1.5	1.5	1.5

Sources: IMF World Economic Outlook (October 2010), European Commission autumn forecast (November 2010) and Consensus Economics Forecasts (November 2010).