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The Reflection of the Current Crisis on the Economic Growth in the European Union New Member States

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Abstract: The paper presents an analysis of the economic growth evolution in the European Union new member states, being part of a more comprehensive research regarding the euro adoption challenges, taking as benchmark Slovakia and Slovenia, countries that already entered the euro zone. The research underlines the fact that, starting with the mid-September 2008, the macroeconomic landscape of the analyzed countries changed radically, registering a decrease of the economic activities determined both by a diminished export activity and by a reduced internal demand, with effects on the firms' profitability and on the deterioration of the labour market situation. The results show that the severity of the financial global crisis effects was different in the analyzed countries, as a response to various "paths" of economic development, with less or more important vulnerabilities, with differences in the extent to which the economies are based on external demand and on credit activity induced from abroad. The countries that are suffering the deepest recessions are those that registered not only a decline of exports, but also a collapse of the internal demand, as a result of stopping the credit activities that were a support for the internal demand.

Keywords: economic growth; global financial crisis; external demand; consumption

JEL Classification: H12; O52

1 Introduction

The forecast for the economic growth remains doubtful in the future, countries just starting to recover from the greatest crisis after the Second World War. The financial crisis and the disequilibria previously accumulated in the economic world, have led to adjustment processes that imply extended periods of weakness in economic activities.

The tension from the sovereign debt market at the beginning of 2010, determined the uncertainty that prevails in the economic forecasts. In the spring forecast, the Economic Commission anticipated an economic growth of 1% in the European Union in 2010, comparing with the reduction by -4,2% in 2009.

The recession was widespread in the European states, although with noticeable differences. Certain European countries were the subject of an intense and/or extended recession, depending on the exposure to the financial crisis and global economic cycle on the one hand, and, on the other hand, depending on the internal and external disequilibria, including here the substantial correction from the real estate market or other local factors. The economic recovery takes place with different steps; in the big states from the European Union, the GDP rate is forecasted to range between 2,7% in Poland and -0,4% in Spain, in 2010. In Greece, the GDP change is sizeable, being negative and reaching -3%. In 2009, among the biggest countries, Germany, France and United Kingdom started to register again economic growth, while Spain and Italy ended the year with their economies still shrunken.

In EU 27, starting with the end of 2008 until the middle of 2009, the GDP contracted for three consecutive quarters, gradually coming back after that. Even if, from the third part of the year 2009, the economy of the European Union reverted to positive economic growth rates (on quarterly basis), these were modest until now. For 2011, the European Commission forecasts a GDP growth by 1,7%.

2 The Economic Growth Tendencies in Europe

Considering the current circumstance of the economies from the European Union, the path of economic recovery is different, more gradual and mild, comparing with the precedent situations. Notwithstanding, the events' chain should be similar with that from the past. The recovery of the European economy is usually based on the exports: the exports increase is made by investment in equipment, investment's rising leads to employment growth that will lead to the expansion of the private consumption. In this way, an essential condition for outrunning the actual stage is the improvement of the external environment. From this point of view, the conditions are favorable starting with the autumn of the year 2009 - the external economic environment may continue to surprise positively, helping the revival of the European exports. The economic measures taken until now seem to be efficient, augmenting the confidence in the business environment and between final consumers that will lead to internal demand refreshing.

Albeit the recurrence of exports increasing is at the basis of the modest economic growth from the European Union, prudence is needed regarding the evolution of the medium term exports. Seeing that the global economy is increasing very slowly in the second part of the 2010, and the complete recovery is not yet certain, the exports rise will be gradual in the next period. Thereby, the channel of investment wherewith the passing towards economic growth is made, apparently, this time is less powerful. Similarly, the evolutions at the national level can lessen the traditional link between exports and investment. Actually, the growth that followed the financial crisis tends to be slower, being behindhand by a reduced private demand.

Table 1 The contribution to the GDP evolution in the European Union (annual percent change)

	2006	2007	2008	2009	2010*	2011*
GDP	3,2	2,9	0,7	-4,2	1,0	1,7
Internal demand	3,0	2,8	0,8	-3,0	-0,1	1,2
Inventories	0,1	0,1	-0,1	-1,1	0,5	0,2
Net Exports	0,1	0,0	0,1	-0,1	0,6	0,3

*Source: European Commission. * Forecast 2010-2011 – European Commission, spring forecast*

The different nature of the European Union recent recession gives the possibility for structural breaks in the traditional relations between economic variables. If we look at the relation between inflation and the difference between real GDP and potential GDP, this link seems to be weaker in the current situation.

One of the consequences of the present crisis is the deterioration of the fiscal position. Although the fiscal incentives and the automatic stabilizers played an important role in stabilizing the economies of the European Union, the quick increase of the deficit and debt shadowed the evolution of the public finance, fact that will be felt on the medium and long term.

A relative fragile situation is that of the financial markets, where even if the conditions are much better than in the previous year, the uncertainty and risks are abundant. Insofar as the improvement of the banking sector conditions is due to governmental policies, the premature retreat of the governmental assistance can have adverse consequences.

The decrease of the internal demand is another risk that endangers the economic growth perspectives. The suspension of the economic incentive measures between 2010 and 2011 and the stopping of the fiscal consolidation phase may affect very much the internal demand. The possibility of maintaining a high cost of the capital constitutes another negative factor.

In EU10, the net exports were the main engine for the economic growth in the majority of the countries in the first part of the year 2010. The net exports were boosted by the currency depreciation in some countries, and, recently, by the recovery of the destination markets for the exports. The internal demand favoured the economic growth only in some countries, investment coming back in Romania and Lithuania. The consumption increased in Poland with the aid of a stable labour market and of a recovered economy. The weak internal demand from the majority of EU10 countries reflects a low level of production capacity utilization, the corrections from the real estate and constructions sectors, and a modest increase of wages and employment rate. Industrial production increased in April, achieving in some countries values with two digits. The economic recovery in EU10, for the entire year 2010, is mainly based on external demand and on inventories' recuperation. The private consumption remains low due to cut wages and modest increase of the salaries both in thepublic and private sectors, due to a high unemployment, to a prudent lending and to weakened fiscal positions. The public consumption will be reduced in consequence of the governmental income reduction and of the inquietudes regarding fiscal sustainability.

On the international plan, a new increase of the oil and other commodities prices may temper the recovery of the global economy. The same effect may have the premature elimination of the incentive measures in the main partner states. The amplification of the social tensions on the background of a high unemployment may lead to the increase of the protectionist measures.

While the situation is generally improving in the developed countries, the economic growth in non-European Union emerging countries and in transition economies is more dynamic. A special case is that of the emerging countries from Asia, China being on the first place. Besides these countries, Russia and Brazil are coming back to economic growth in 2010, due to, *inter alia*, the reduction of commodity prices and theamelioration of internal demand. The emerging economies from Asia and Latin America are strongly increasing, being supported by a great internal demand and the recurrence of commercial flows. Among the developed countries, USA and Japan are on the first places in terms of economic recovery, the confidence increasing between consumers, businessmen, and on the financial markets. In Europe, which was the most affected by the crisis comparing with other regions of the world, the economies became stable, and for the first time from the beginning of the crisis are coming back on an increasing trend in 2010.

Table 2 Economic growth perspectives, percent change

	2009	**2010***	**2011***	**2012***
Economic growth on the global level	**-2,1**	**3,3**	**3,3**	**3,5**
EU10	-3,6	1,7	3,3	3,7
Countries with high income	**-3,3**	**2,3**	**2,4**	**2,7**
Euro zone	-4,1	0,7	1,3	1,8
Japan	-5,2	2,5	2,1	2,2
USA	-2,4	3,3	2,9	3,0
Emerging countries	**1,7**	**6,2**	**6,0**	**6,0**
Brazil	-0,2	6,4	4,5	4,1
China	8,7	9,5	8,5	8,2
India	7,7	8,2	8,7	8,2
Mexico	-6,5	4,3	4,0	4,2
Russia	-7,9	4,5	4,8	4,7

*Source: World Bank, Global Economic Prospects June 2010, *economic forecasts*

In EU10, the economic growth recovery is relative, the starting base being very small due to last year recession. The economic growth in the first quarter of 2010 was only 0.2%, comparing with 0.5% in the last quarter of 2009. With the aid of the commerce and economic activities' revival on the global level, we expect an economic growth by 1.7% in 2010 in EU10, comparing with only 0.7% in the euro zone.

3 Developments in the Economic Growth of the European Union New Member States before and after Global Crisis

The **Baltic States** were the first countries which recorded economic slowdown, although the reasons were not related to the initial global crisis. Gradually, they became the most severely affected by the financial market turmoil and by the reduction in the global trade (see Chart 1). The Baltic countries have suffered a collapse of internal demand and lending activity, with a sharp current account adjustment, justifying the idea that, under shock, a rapid economic boom could turn into a dramatic collapse.Such a phenomenon has been caused by the unsustainable growth of these economies in the recent years. Thus, after the Russian crisis during 1997-1998, the Baltic States experienced very fast economic growth rates, enhanced by the rapid integration with the more developed Nordic countries.

The positive expectations regarding the evolution of these economies were boosted further by both the European Union accession and entering the ERM II. On the demand side, the key driver behind this development was the easy access to bank lending which has induced a pickup of the domestic demand. Both, the positive expectations about the rising household incomes and the low levels of real interest rates on euro denominated loans have sustained the borrowing demand. On the supply side, the bank lending activity was largely financed from abroad (by parent banks from the Nordic developed states). The increasing lending activity and the capital inflows to the Baltic countries (as percentage of GDP) have been impressive, exceeding the levels of the other new member states. In this context, the Baltic economies eventually have suffered overheating (especially Estonia and Latvia). Such a phenomenon was fuelled by the increasing absorption of EU funds and by the expansionary fiscal policy. The vulnerabilities of these developments have been reflected, both in a decreasing competitiveness, by the rapid real exchange rate appreciation (on CPI-basis) during the economic expansion, with the wage growth exceeding productivity gains, and in an increasing degree of indebtedness of the private sector (particularly in Estonia and Latvia). These were the effects of the fixed exchange rate arrangements combined with the inconsistent macroeconomic policies. The economic overheating has also spurred the increase of the public expenditures.

Macroeconomic conditions have deteriorated sharply since the end of 2008, with an economic downturn brought by the decrease of both exports and domestic demand, which have reflected on the companies' earnings and labour market deterioration.Countries with the deepest recessions are those who have registered not only a decline in exports but also a collapse of domestic demand (an effect of this), due to the containment of bank lending – an important driver for sustaining domestic demand (Latvia, Lithuania, Estonia). In contrast, countries that had the lowest decline of economic activity have the strongest recovery (Poland).

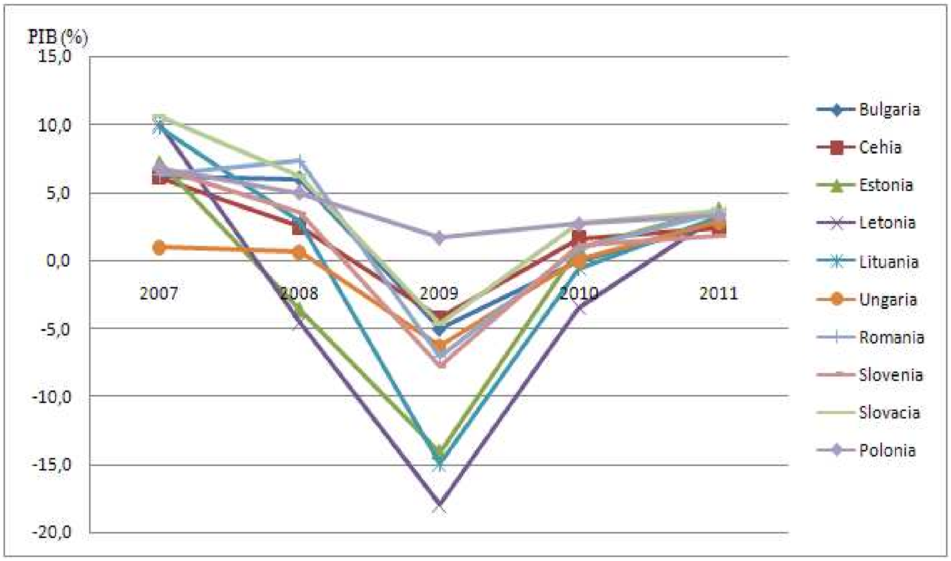

Chart 1. GDP growth rate in the EU new member states, between 2007-2010, and in 2011 (forecast) (Eurostat database)

After several years of buoyant growth the economy of the **Czech Republic**[1] was hit by the global crisis which generated a deep recession. This highly opened and strongly integrated economy was strongly affected through the external trade channel releasing a chain reaction: the decrease of the export activity has brought a decline of the manufacturing sector, with the automotive industry being particularly affected, and the deterioration of economic activity induced adjustments on the labour market. However, the strong economic fundamentals, generated by sound macroeconomic and structural policies, have helped this

[1] IMF ranks the Czech Republic among the developed countries, in line with Sweden, United Kingdom, Slovenia or Slovakia. Such a rating for the Czech Republic and Slovakia is available since 2009 (IMF, 2010). By that moment, they were considered emergent countries (IMF, 2010)

country to face challenges derived from the global crisis. The Czech economy is still lagging below the EU average in terms of labour productivity, but the catching-up process runs fast. The main drivers of economic growth are the total factor productivity and the capital deepening.

The **Polish** economy has experienced a favorable period (between 2003 and 2008) characterized by a robust economic growth, a decline of the inflation phenomenon and a decrease of unemployment rate. The global crisis has changed the picture, bringing a significant slowdown of the economic activity, in 2009. However, there have been some factors which helped the economy to be kept afloat: the strong economic fundamentals with a well-capitalized and sound financial sector, a relatively low degree of economic openness, a significant depreciation of the Polish zloty at an early stage of the crisis, and timely reactions from monetary and fiscal policies. Therefore, Poland was the only EU country with positive growth in 2009 (see Chart 1). In the future, the expectations regarding economic recovery remain optimistic.

Hungary was already in a difficult economic situation when the financial crisis broke out in autumn 2008, although it had been consolidating its public finances some years before that moment (in 2006). For several years, the labor productivity and the potential output began to decrease, while domestic demand was boosted by the relaxed fiscal policy at the beginning of 2000s, and also by the increasing of private sector indebtedness. The program for fiscal consolidation has been implemented in order to redress the old problem of twin deficits[1]. In 2007 these deficits have decreased, but at the same time the GDP growth rate has been also decreasing. The increase of investors' risk aversion induced by the global crisis has deteriorated the economic activity in Hungary and the government's external financing needs could no longer be met through the market channels. In 2009, the foreign trade (exports) and the industrial production have strongly diminished, after the sharp decrease in external demand and the high uncertainty about the severity and duration of the crisis.

Between 2004 and 2008, **Romania** has recorded one of the fastest economic growths among the countries of the European Union, with an average annual growth rate of 6,8 percent. This performance was induced by the buoyant domestic demand, both consumption and investment, which has been fuelled by large capital inflows, including those related to the rapid expansion of bank lending (financed

[1] The values of fiscal and current account deficits were rather at high and close levels.

mainly by foreign parent banks), and by positive expectations on higher incomes. However, the economic growth has been accompanied by the increase of external and fiscal imbalances. The deepening of the global crisis and the increase in risk aversion on the international markets caused a strong downturn in capital flows and exchange rate depreciation. While the economic activity has lowered significantly, with the contracteddomestic demand, the inflation rate has decreased only slightly, remaining at high levels compared with other countries in the region, reflecting the labor and product market rigidities. In this context, the current account deficit has suffered dramatic adjustments. Also, the potential output of Romania has been lowered by the global crisis, through the decrease in capital accumulation, and by the effects of aging of population and migration. The capital accumulation, both in the public and private sectors, has been undergone by the decrease in foreign investment and by the constraints on the credit availability. The economic forecasts are not so optimistic, because the applying of austerity measures has had only a limited and temporary effect on the internal imbalance, the recession becoming chronic.

Before the crisis, **Slovenia** has enjoyed robust economic growth based on the buoyant exports and investment. On the other side, the inflationary pressures since 2007 have widened the external deficit. Slovenia entered the euro zone in an optimistic period, with strong international liquidity. The lower real interest rates have fuelled households borrowing and the domestic demand has increased. This tendency inflamed imports, while accelerating wage growth worsened the country economic competitiveness. In autumn 2008, the rapid expansion of Slovenian economy ended, due to the impact of the global crisis. The trade channel was the most important transmission channel of these effects. Thus, the economic growth has abruptly contracted in 2009, being estimated as one of the largest contraction in the euro area. The drivers of this collapse were exports and investment, including a massive drop in inventories. The economic slowdown caused a rapid worsening of budgetary position, but on the other side, this economic downturn has brought the inflation rate downside (narrowing the gap against the euro area average inflation rate), as well as the current account deficit. The Slovenian economy has a better position than other European countries in terms of structural adjustment or imbalances. Therefore, the economic recovery for Slovenia is estimated to be faster, and the impact of global crisis on the potential growth will last only on the short time. However, the persistent vulnerable factor remains, like in the other European Union new member states, the large gap between Slovenian productivity and other euro area countries productivity, in terms of capital deepening and total factor productivity.

Slovakia has experienced several years of rapid real convergence and GDP per capita (in purchasing power parity) gradually approached the level existing in the developed countries of the European Union. In 2009 economic activity was reduced due to a drop of the external demand and investment, but in 2010 the economy returned to growth trend (GDP growth rate is positive). The explanation for this return is given by the increasing exports and domestic demand, the latter being supported by the free operation of automatic fiscal stabilizers and to a certain extent by the anti-crisis measures taken.

4 Conclusions

This financial and economic crisis has affected the new member states of the European Union through three main channels: the external demand channel (a lower demand for exports), the investment channel (a lower foreign direct investment) and the credit channel (the slowdown in credit growth). The impact of the global crisis has been reflected to a different extent on these three channels in the European Union new member states, depending on the internal characteristics of these countries. The decline in external demand has been felt more strongly in countries that have followed an export-led growth model, e.g. the Czech Republic and Slovakia. The investment sluggish induced by capital flight and the slowdown of lending were significant in those countries which have developed either on the consumption-led growth model, or on the foreign investments directed towards the non-tradable sector.

Looking ahead, the economies of the European Union new member states will recover slowly, given the weak domestic demand, which is the main economic growth driver in these countries. Domestic demand will remain in a vulnerable position, as a result of several factors which work in the environment created by the global financial crisis. Thus, the net capital flows and the lending growth rate for the private sector will continue to be at low levels in most European Union new member states. The net FDI levels are below those recorded before the outbreak of the economic and financial crisis, and other investments flows are negative (in Bulgaria, Estonia and Lithuania) reflecting the debt payments of banks and corporate sector. The credit growth of the private sector remains low due to the high volume of bad loans, as well as the sizeable financing costs (including external sources) which tend to reduce the supply of credit. Moreover, the investments tend to be hampered by the excess capacity of utilization, because the output is yet below the level recorded before the crisis episode in most European Union new member states, particularly in the non-tradable sector, where the booming activity during the "overheating years" has frozen. Besides these factors, the bad conditions in the labour market, as well as the declining of population wealth, will confine the consumption.

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