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Effects of the Euro Crisis on Europe's Periphery (East, South and Southeast)[1]

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The situation in the European Union has now developed into a make or break situation. This is not only relevant for EU member countries, but is of great relevance also for the countries which are politically or economically closely connected with it. Since mid-2011 growth in the European Union has slowed down and a mild recession or stagnation is being forecasted for 2012 with slow recovery in the medium run. The performance has differed and will differ significantly across regions depending on their strengths and weaknesses. They will all, however, be constrained by the common EU economic policy framework which is emerging as a response to the crisis. Thus, new divides are opening up in the EU and in Europe in general. The main one is between the industrialized and competitive 'North' and the indebted and mostly service-oriented 'South'. There is also a further group of countries, including resources-rich countries in the Eastern Neighbourhood and fast developing Turkey with policy problems and advantages of their own. In this paper we shall focus in a comparative manner on developments in Central European countries (including Poland, the Czech Republic, Slovakia, Hungary, and Slovenia), the GIPS countries (Greece, Italy, Portugal, and Spain; occasionally also Ireland), the Baltic states, Southeast Europe (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania, and Serbia), and finally Russia, Ukraine, Kazakhstan and Turkey.

The underlying driver of the 'New Divides in Europe' is the build-up of external imbalances prior to the crisis within the EU and with the countries in Southeast Europe closely connected with the EU. The causes of this build-up are by now well known as is the inadequacy of the inherited institutional and policy framework of the EU and the eurozone in particular. In the course of policy responses to the crisis, the EU is developing a new framework in which one of the main pillars is fiscal restraint now formalized in the fiscal compact. In addition, monetary policy has been relaxed and institutions have been set up to deal with the problem of stabilization support and debt resolution; most recently an initiative has started to move towards a 'banking union'.

This policy framework deals mainly with stability while growth is expected to be spurred by structural reforms, i.e. by supply-side policies. The risk is that these policies for stability and growth may deliver a prolonged period of stagnation with high unemployment in countries and regions that need to deleverage and build up their tradable sectors. With exchange rate rigidity and fiscal austerity, it may take considerable time for these countries to recover. That will severely test the weaker economies of Europe, those in the GIPS group as well as the Balkan

[1] This talk draws on the study "Macroeconomic developments and policies in Europe since 2008: New Divides in Europe" written for ILO in 2012.

economies and in a different way also some of those in Central Europe and in the Baltics. This in turn can have severe repercussions on the EU set-up as a whole.

Imbalances, debts, and prospects for investments

The analysis in this report draws the following conclusions in the contexts of growth slowdown and the emerging policy framework:

- The most distinctive differentiating feature among the emerging European economies that the analysis singles out was the pre-crisis build-up of (structural) current account disequilibria, associated developments in external debt and the debt positions particularly in the private sector (households and corporations). The previous build-up of disequilibria and debt accounts for most of the differentiated impact of the crisis over the period 2008-2011.
- A sub-group of three Central European economies (Czech Republic, Poland and Slovakia) has been scarcely affected by the debt build-up. The countries concerned showed little sign of competitiveness problems in their tradable sectors (which is also the case with Hungary), while the GIPS (Ireland's problems were debt-, not competitiveness-related) and most of the countries in Southeast Europe and the Baltic states developed unsustainable disequilibria in both of these respects.
- As to the prospects for 2012 and 2013, the situation is rather grim for emerging Europe. With growth slowing down significantly in the advanced parts of Europe, pursuit of an 'export-led' strategy (as pursued over the biennium 2010-2011) is hardly an option, while the greater reliance on domestic demand factors that the situation requires also faces severe problems. Our analysis evaluates the various aspects (fiscal, household and corporate) of the 'debt problem' in the various groups of countries:
    - First, the analysis addresses the differences in scope for fiscal policy from the standpoint of the sustainability conditions for public debt: (i) in the face of changed and differentiated growth prospects; (ii) interest rate perspectives (the latter in turn reflecting the financial markets' evaluation of sustainability issues); and (iii) the policy stances adopted by different governments.
    - Thereafter, the analysis assesses the likely recovery prospects of corporate investment activities and household consumption expenditures. For both items inherited debt levels and deleveraging processes, as well as income and sales prospects are seen to be major determinants (all of which, in turn, affect financing conditions). Country groups differ in those respects, just as they differed in the build-up of public debt in the course of the crisis.
- Important groups of economies, such as the GIPS countries and most of the countries of Southeast Europe and some countries in Central Europe (Slovenia, Hungary), have come up against a vicious circle: high initial debt levels and dim growth prospects translate into greater doubts about sustainability and hence into higher interest rates that impose a constraint on investment and encourage corporate and household deleveraging (further compounded by the weak state of the banking system). This dampens consumption expenditures, and leads to cutbacks in employment (and wages), which, in

turn, lower household incomes and domestic sales prospects. The induced lower growth prospects, in turn, raise concerns over debt sustainability and the need to keep interest rates high.

- Prospects of offsetting factors such as a potential rise in competitiveness and hence export-led recovery are dim in the current context of low growth in the European economy as a whole.

Conclusion

The report thus points towards a sustained period in which the income convergence processes which characterized the decade prior to the current financial and economic crisis will either not proceed or proceed at a much reduced pace. Deleveraging processes, difficult moves to deal with the high debt positions of the private sector, the weak banking system and tendencies towards national fragmentation of financial markets in Europe, as well as the feedback effects on sovereign debt will characterize many of the lower-income economies in Europe. The driving force of foreign direct investment and the build-up of cross-border production networks will also show weaker momentum compared to before the crisis. Adjustment processes to deal with the pre-crisis neglect of building-up a viable tradable sector and sufficient and modernizing export capacities will have to gain priority and the use of different sets of policy instruments (particularly in the areas of training, labour market, industrial and regional policies) will have to be strengthened.