Abstract: In the context of the recent financial crisis, the macroeconomic stability of most countries has been cast to shadow. The damage to the economy caused by high inflation, volatile exchange rates, increasing amount of debts and the unstable financial markets has heavily left its toll on the global market and has led to massive unemployment and increasing poverty. This paper aims to follow the eight new Central and Eastern European countries that joined the European Union in 2004, as well as Romania and Bulgaria, who followed suit in 2007, in what concerns their economical performance, following adhesion to the EU while also comparing the periods before and after the economical crisis. They were chosen as a topic of research for the severity with which the crisis affected them and the high degree of reform implementation in the aftermath. It also plans to highlight the effect of the new reforms and the growth potential when compared to the rest of the European Union. The price inflation, real GDP growth, the levels of (un)employment, fiscal policy and stability of exchange rates will provide a clear image of how this cluster of developing countries fare nowadays against the rest of the EU countries.

Keywords: GDP growth; unit labour cost; unemployment; current account; budget deficit

INTRODUCTION

Most of the eight Central and East European Countries (CEE), who joined the European Union in 2004, as well as Romania and Bulgaria, who adhered to the European Union three years later, were heavily affected by the global financial crisis that occurred in late 2008. In the aftermath of it, a lot of lessons were learned and a lot of reforms were implemented with long-term positive as well as some negative implications.

Just before the crisis hit in its fullness, most of the CEE countries already showed major concerns. Hungary was still dealing with high public debt and long lasting fiscal problems. The Baltic countries, as well as Bulgaria and Romania were facing a current account crisis, while the former two had double digit inflation figures by 2008. After the crisis began, output started to constrain and unemployment reached new highs. Romania, Hungary and Latvia needed in the aftermath rescue programs from the International Monetary Fund (IMF).
By 2010 however, almost all the countries started to recover and exhibit economic growth and signalled that they managed to overcome the crisis. I will first offer a macroeconomic analysis of the situation before and after the crisis, in order to provide a quantitative picture of the extent to which the countries fared during and in the aftermath of the crisis. I will then try point the main reforms carried out and whether or not they provide the structure for future economic growth.

1. MACROECONOMIC ANALYSIS

It is interesting to notice that the countries that experienced the largest growth before the crisis, more exactly Latvia, Lithuania and Estonia are the ones that underwent the largest contraction when the crisis hit the hardest, with Romania and Bulgaria showing a similar trend. The three Baltic countries are the only ones that recorded a double-digit contraction with a staggering 14% reduction of the GDP at least for each one in 2009. Similarly, after they recorded a steady growth of around 6% before the crisis, Romania and Bulgaria witnessed a 6.6%, respectively 5.5% contraction in 2009. By 2011 however, all the CEE countries exhibited growth once again.

The pre-crisis rapid growth was accomplished at unsustainable rates in these countries, thus creating strong internal and external imbalances. The credit boom allowed a major rise in the prices of the assets, mainly the house prices. As shown by the deflated house price index, which measures inflation in the house market relative to the inflation for private final consumption expenditures, the boom of 23.6% increase in one year in Latvia was followed by a 39.2% decrease in 2009, with all three Baltic countries as well as Bulgaria and Romania witnessing decreases of over 20%. The wealth excess further provided increases in demand and rising wages which then lead to strong increases in the nominal unit labour
cost, which is the ratio of labour costs to labour productivity. This indicator reflects both the amount of labour costs needed for the production of one unit of GDP, as well as the interdependence of labour costs and productivity with respect to the formation of the GDP. The overall consensus is that the unit labour cost should increase slow and steady and the changes in labour costs should be on par with those in productivity in order to stimulate competitiveness (Mertsina and Jänes, 2012). However, in 2009, based on a three year average the changes peaked at more than 35% in Bulgaria, Latvia, Estonia and Romania, with a record high 45.7 increase in the latter.

![Figure 2 - Nominal unit labour cost 3 years % change](source: Eurostat (online code tipslm10))

Improvements in the competitiveness of cost translated in general for the emerging economies into a surplus in the trade balance (Richard, 2011). Therefore, we assume there is an inverse relationship between unit labour cost and the exports of a country, with an increase in the former affecting the overall export benefits. This is indeed true when regarding the same period for total exports compared to the unit labour costs, with exports diminishing in every one of the ten countries between 2008 and 2009.

The budget deficit also started to rise before the crisis in most of the CEE countries due to increased growth and overconfidence of the governments in terms of forecasted output but it still wasn’t significantly high in 2007. With the onset of the crisis however, governments were forced to spend more in order to reboot the economy and the deficits increased alarmingly with the peaks occurring in 2009 in
most countries, with Romania, Lithuania and Latvia leading the pack with over 9% of their GDP as budget deficit.

**Figure 3 – Exports in 1,000 million**

Source: Eurostat (online code tec00038)

**Figure 4 - Budget deficit 2007 - 2009**

Source: Budget deficit 2007-2009 (online code tec00127)
All the countries with the exception of Poland and Slovenia have managed to reach their intended purpose of reducing their budget deficits to under 3% by 2013. This is in opposition to countries like Spain, Portugal or Greece, which still exhibit high deficits as of the last year.

Figure 5 – Budget deficit 2013

Source: Eurostat (online code tec00127)

The situation in Slovenia is particular with the deficit standing at 5.188 million euros or 14.7% of GDP in 2013, but this is expected to slide back to around 4.1% of GDP in 2014, according to the Statistical Office of the Republic of Slovenia. This is mostly due to a double dip recession in which Slovenia crept into in 2012, a crisis due to the banking sector which was still accountable for bad loans. After a 3.6 billion Euros package invested by the government in 2013, Slovenia is expected to have a balanced budget by 2017 (Novak, 2014).

Before the crisis the public expenditures of CEE countries was lower than that of EU-15, who had expenditures of around 47% of GDP on average. Naturally, as the government tried to invest in the recovery of the economy the public expenditures grew as a percentage of GDP.

After a much lower figure than their western counterparts, the CEE countries reached an average of about 45% of GDP in 2009 at the peak of the crisis. However, we must take into account the contribution of Hungary to this figure, since it exhibits the highest degree of public spending with over 50% of GDP between the above mentioned dates. At the other side of the spectrum, Romania and Bulgaria reported the least amount of public spending, with 41% of GDP being directed towards expenditures at the peak in 2009. The situation is worrying in Hungary since it has the highest amount of public expenditures yet has one of the
lowest amounts of spending on social protection as a share of total budget and is the only one that has healthcare spending out of the top three priorities (Dewan and Ettlinger, 2009). Thus the burden on its citizens and on its social protection system is of great significance, macroeconomic stability being obtained through political stability as well. Overall however, it is positive to note the fact that CEE countries, as opposed to countries from Western Europe, have managed to refrain themselves from substantial state aid, safeguarding their budget balance by curbing on their public expenditures.

The current account witnessed some staggering fluctuations in the years before and after the crisis. In Latvia, one of the largest growth per year occurred between 2008 and 2009 when the country experienced a 21.8% increase in its current account from a deficit of 13.2% of GDP in 2008 to a positive balance of 8.6% of GDP in 2009. Lithuania witnessed a similar trend, from a deficit of 12.9% to a surplus of 3.7% of GDP, an 16.6% increase in only year, as did Estonia with an 12.6% increase, who was the only other country from the CEE to output a surplus on its balance in 2009. The CEE countries have fared fairly well against their southern counterparts, with Greece experiencing a 11.2% deficit and Portugal a 10.9% one in the same period, while Italy and Spain have put forth a deficit of around 4% in 2010, still higher than most of the CEE countries.

In terms of current account balance, it is reasonable to divide the 10 CEE countries into two main groups: core countries, that exhibited moderate year-to-year fluctuations like Poland, Slovenia or Slovakia and periphery countries that underwent extreme year-to-year fluctuations like the Baltic countries. According to Harkmann and Staehr (2012), econometric analysis reveals that in the core countries, the current account balance is due partly to convergence effects and
internal factors like competitiveness and fiscal policy, while in the periphery group it was partly due to risk pricing in the EU financial markets, capital flows to the region and sentiments regarding internal development. To sum it up, in the countries that exhibited moderate fluctuations, the current account balance was mainly driven by policies and effects of convergence, while for those countries that underwent major year-to-year fluctuations, this was mostly due to sentiment effects and external factors (Harkmann and Staehr, 2012).

**Figure 7 - Current account as % of GDP 2008-2009**

![Current account as % of GDP 2008-2009](image)

Source: Eurostat (online code tec00043)

The annual average inflation rate as measured by the Harmonised Indices of Consumer Prices (HICP) displayed alarming double digit figures before the onset of the crisis in 2008 in countries like Bulgaria and the Baltic States. The large numbers were spurred by the credit boom, however as a normal consequence of the crisis, the figures rapidly fell down due to minimal credit being handed out, low domestic demand and a general reduction in global commodity prices, with Romania being the only country out of the CEE to display inflation rate of above 5% in 2010.

The steepest decline occurred in Latvia, who before the crisis had the most massive HICP rate of all then countries, with a staggering 15.3% in 2008, ending up just two years later as the only country with deflation at 1.2%. By 2013, the risk of a deflationary cycle was considered inexistent, with Latvia reaching a null rate, whereas fears of an inflationary cycle were proven wrong, Romania and Estonia being the only countries with an inflation rate of over 3% and all the other ones exhibiting below 2% levels.
Figure 8 - HICP inflation rate 2008-2010

Source: Eurostat (online code tec00118)

Figure 9 - HICP inflation rate 2013

Source: Eurostat (online code tec00118)
The labour market proved one of the most difficult sectors for reforming due to the political implications as well. Before the onset of the crisis, most countries experienced significant increase in employment, with the exception of Hungary which saw a decline between 2007 and 2008. As a result of the economic crisis,
The countries most impacted were once again the Baltic ones which experienced the highest decline. As a consequence unemployment soared in the period 2009 to 2012 with the Baltic countries being of course the major player. Increasing worrying double digit figures were however still recorded in 2012 in Bulgaria and Hungary, with around 11% unemployment rate and a very high 14% in Slovakia. Still, the CEE did substantially better than other Southern European countries, with Spain peaking in at 22.3% in unemployment in 2012, followed by Greece with 18.2% and Portugal with 13.6%. One can observe the gravity of the change when considering that in 2007 six countries of the CEE were among the twelve countries of the EU with an unemployment rate of 6 or less per cent (Dymarksi, 2010).

2. REFORM IMPLEMENTATION AND THEIR EFFECT

The global financial crisis demanded extreme measures from the governments of the CEE countries. Massive fiscal adjustments were carried out, public expenditure was cut, as were wages, especially in the public sector. Due to the fact that public expenditures had significantly increased pre-crisis, most of the CEE countries, especially the Baltic ones and Hungary, which as demonstrated previously had the highest percentage of public expenditure, were thrown in the mist of the recession ridden with fiscal imbalances.

In these Baltic countries, in order to implement a successful fiscal adjustment strategy, it was first needed to reduce fiscal funding needs, restore deficits according to the Maastricht limit of 3% of GDP and keep up with a correction of the real exchange rate in order to restrain domestic demand growth, thus keeping in line with the convergence criteria for a faster adoption of the euro. Then competitiveness was to be achieved by decreasing labour costs, in both sectors of the economy, this measure having also the support of the traditional labour market flexibility of the Baltics. Moreover, it was important to maintain financial stability by securing liquidity in the banks and providing adequate capitalization. On a final note legal measures were introduced in order to circumvent the traditional legal frameworks so as to provide help to private corporate and households balance sheets, by reducing their debt, without the state actually intervening. As previously shown above, the Baltic countries had one of the highest budget deficits out of the CEE countries, but the situation could have been gloomier according to IMF estimates, that predicted deficits of around 16 to 18% of GDP in Latvia and Lithuania and around 10% of GDP in Estonia, had the aforementioned fiscal measures hadn’t been introduced. As a result these countries embarked on unprecedented fiscal adjustment, this totaling more than 11% of GDP in only one year in Latvia with the result being that the deficit in 2009 ended at only 9% of GDP (Purfield and Rosenberg, 2010).

Other fiscal policies included modification of the tax system. Thus, in order to stimulate work and growth, the taxes have started to concern more consumption
and property in the detriment of profits. Lithuania and Latvia, as well as Hungary and Romania needed to raise their VAT tax in order to cope with the crisis, with Romania recording the largest increase from 19% to 24%. The lowest rate of corporate income tax is in Bulgaria with 10%. Latvia and Lithuania have 15%, Czech Republic, Slovakia and Poland cloak at 19%, in Slovenia it is 20%, followed closely by Hungary at 20.6% and Estonia with 21%. Personal income rates are the same as corporate ones in six out of the then countries, namely Romania, Bulgaria, Hungary, Estonia and Slovakia, while In Latvia it peaks at 25%. However, the potential gains from a flat tax rate are uncertain and they depend on other factors as well, like the content of the reform (Radulescu, 2011). But given that the CEE countries have a low flat income tax, while the corporate income tax follows the same trend, this provides the necessary environment for sustaining a culture of work and entrepreneurship, one that is needed for sustainable growth. Property taxes also experienced an increase in percentage points in some countries but in cases like Romania, this was abolished by the Constitutional Court.

In order to curb the public expenditure, severe wage cuts were employed, especially in the public sector (public administration, education and health care). In Bulgaria, the government eliminated the predicted wage increases in these sectors. This plummeted nominal and real wage growths, with the rate of increase of nominal wages in education falling down from 21.7% in the first quarter to only 8% in the last one and that of real wage increases falling from 15.8% to 7.1%, while the trend in the health care was similar. In public administration the situation was worse, with growth rate turning to negative in the last quarter of 2009. The following reforms cancelled any increase in public wages from mid-2009, as well as freezing both the public sector wage and the minimum wage until 2010. The effects were visible on-hand, with wages of employees in the aforementioned sectors remaining at 2008 levels. The minimum and public sector wages reduced in real terms, the gap between wages in public and private sectors diminished and the reduction of the salaries in these sectors translated into decreasing internal consumption and demand which is not beneficial to economic growth.

In Hungary the situation was grimmer due to the severity of the crisis. Since it required significant help from the IMF and the World Bank, Hungary was poised to their restriction and the government had little free-hand. Thus they committed to safeguarding the budget deficit under 4% and introduced significant austerity measures, eliminating the thirteenth-month wage in the public sector and a freezing of them which equated into a 11.5% decline in salaries of public functionaries. Working hours were also reduced. Since the Hungarian government had no option when it came to implementing their own reforms, being restrained by the IMF, they had to reduce the budget deficit by either dismissing thousands of workers or by cutting down on wages, and the latter was clearly more favorable from a political context. This had the effect of increasing wage inequity, but this only grew slightly between 2008 and 2009, the private sector having little part in that. Hungary also raised their retirement age in order to deal with the burden of the pension costs.

In Romania compulsory unpaid leave was introduced in the public sector along with the abolition of bonuses in 2009. Another set of constraining measures
in 2010 enraged public workers who took to the streets. In education, wages were cut overall by 25%, in the public health sector by 20% and in the public administration by 13.9%. The effect was a growing wage inequality of a much higher degree than in Hungary, with wage disparities reaching figures higher even than in the 1990s. Romania still had in 2009 the lowest minimum wage out of all Member States, by 0.96 euro per hour. Individual work contracts were renegotiated for workers from state-owned companies and cases were dismissal was introduced, followed by re-employment at a much lower wage were frequent. The income tax hasn’t proven itself efficient in getting rid of the informal economy and was only used as a fiscal tool for obtaining direct tax with no long-term revenues. However, on a positive note, pressured by the loan from the IMF, the government introduced a law that harmonized wages in the public sector according to responsibility, amount of work and qualifications. But the Romanian labour market is still poised with inflexibility and insufficient capacity to incorporate unemployed citizens (Schmidt and Vaughan-Whitehead, 2011).

Overall, the share of social protection in terms of public expenditure increased in all CEE countries with the highest increases in Bulgaria, Estonia, Latvia and Romania, with around 7 to 8%. Reductions in terms of education, public order and general public affairs were the most pronounced as evidenced above, while in terms of economic affairs and health the changes were country specific. A reduction of the gross fixed capital formation share was also registered, as was one in the relative share of compensation of employees according to a European Comission report from 2012. As Zugravu and Sava (2014) point out, general economic, commercial and labour affairs expenditures usually have a negative relation with respect to GDP growth, while spending on agriculture, transport, R&D and the development of small and medium sized enterprises have positive connotations (Zugravu and Sava, 2014). In that regard, the reforms undertaken by the governments of the CEE countries in light of the crisis have been fairly justified, with the decrease in public sector expenditures possibly providing for future economic growth, although more progress needs to be carried out in investment spending in order to benefit the SME and provide for job creation.

3. FUTURE GROWTH POTENTIAL

In light of the reforms implemented in order to combat the economic contraction, we try to measure their effectiveness and see if pillars were laid for future economic growth. In order to create growth, an environment friendly to business needs to be in place in order to attract both internal and external investors. This can be done by identifying, supporting and further developing their main competitive advantages. One of those is their competitiveness, which is fueled by a regulatory environment promoting the creation and well-running of firms. An indicator that measures just that is the World Bank’s ease of doing business index. Lithuania is the highest classed country out of the CEE on the 17th place overall, with Estonia and Latvia coming in at 22 and 24 respectively, followed by Slovenia in 33th position. Poland and Slovakia rank middle way at 45th, respectively 49th
place, as does Hungary at 54th and Bulgaria at 58th. The countries with the most challenging environment in which to do business out of the CEE countries are Romania at 73th and the Czech Republic at the 75th overall place. While Estonia, Lithuania and Latvia are 45, 47 and 53rd in the International Monetary Fund’s GDP per capita at purchasing power parity list, this means there is significant room for improvement and future growth when compared with the ease of doing business ranking. On the other side of the spectrum, the situation is worrying in the Czech Republic which ranks 37th in the GDP per capita list, but only 75th place in the ease of doing business ranking, signifying growth potential loss.

Also, as a consequence of the massive wage cuts and austerity measures introduced in the aftermath of the crisis, the real unit labour cost fell in most countries with the highest reductions occurring in Romania and the Baltic countries. This translates of course also into increased competitiveness.

![Figure 12 – Real unit labour cost growth 2009 - 2011](source: Eurostat (online code tec00130))

The real effective exchange rate, which is based on the unit labour cost, fell down especially in Latvia and Poland but also in the other Baltic countries. It appears that the steep depreciation has provided countries with flexible exchange rate regimes to restrain the decline in exports as a report of the ECB points out.

According to a PwC Polska report (2013), growth in the CEE region can be measured through five key determinants: Access to markets, Resources for growth, Cost Competitiveness, Growth Sustainability and Business Environment Indexes. The access to global markets is guaranteed by the EU membership. The region can boast itself with reliant future growth due to the high degree of foreign direct investment, created by competitive labour cost and low corporate income taxes,
outstripping the more developed countries from Southern Europe in this regard. In terms of resources for growth, the CEE countries dispose of excellent human capital, with a large pool of tertiary educated and in good health working force but providing only modest saving rates, even though they compensate a bit through the low cost of credit. The CEE countries from the southern part fare the worst in terms of this indicator against all other EU countries, partly due to the scarcity of the innovation role in the economy, with R&D activities amounting to very little in countries like Romania and Bulgaria. CEE countries possess however the biggest advantage when it comes to cost competitiveness, which is the ratio between costs and quality of work. The South CEE countries like Romania and Bulgaria are the strongest in this aspect with low costs, yet highly qualified labour force, providing them an increased competitive advantage in attracting FDI. When considering growth stability, the CEE countries are still behind the Northern countries but are doing well better than their highly indebted Southern European counterparts, with financial sustainability looking pretty good when considering the stable banking sector (Slovenia being an exception to this rule), as does political stability that seems to have taken over the region. Nevertheless, the Environmental sustainability leaves much room for improvement, especially considering the lack of convergence to the EU climate policy. Almost all of the CEE countries do however have a good business environment, by this umbrella term understanding the mix of government institutions, tax system, infrastructure and transparency of the economy. The former presents a rather worrying index due to the public sector reforms that have swept the CEE countries following the crisis as does the infrastructure, which still lags behind all other members of the EU. Positive signs are coming from the taxation system, which is one that provides the highest incentives for investment in the south CEE members. The lack of enough transparency of the economy is one of the major issues affecting this cluster of countries, with the main culprits being corruption and an abundance of informal economy, especially in the south CEE states. Overall, the conclusion that can be drawn from these indicators is that the CEE countries ought to pay more attention to their business environment and growth stability, which require little cost but can significantly raise the investment potential of the countries.

CONCLUSIONS

Based on the analysis of macroeconomic indicators like GDP growth, current account balance, HICP index, budget balance, unemployment and public expenditures it is reasonable to conclude that the CEE countries have mainly overcome the crisis, with growth starting to resume, albeit at much slower rates than before the crisis. Most of the countries have managed to reduce their budget deficit under the Maastricht limit of 3% of their GDP and the current account balance was greatly stabilized after abnormal fluctuations. Inflation was curbed down due to the decrease in domestic demand and public debt has been kept under the Maastricht limit of 60% in all countries but Hungary, which we can say is the only one that hasn’t come out entirely of recession.
The reforms concerned mainly the reduction of public expenditures in the detriment of tax increases, which has proved successful and has also improved the quality of the public apparatus by “trimming” the unnecessary.

The Central and Eastern European countries exhibit great growth potential, based on cost competitiveness and providing great access to their markets, while at the same time needing to improve their business environment and growth sustainability in order to attract more foreign investment.

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