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Central Europe's Economic Path in mid-2011

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International economic relations of countries in Central Europe underwent radical change between 2004 and 2007 on account of the two enlargement waves of the European Union, creating new conditions for economic development and convergence. EU accession lent new momentum to the economic growth and therefore convergence of all the new Member States including V4 countries – with the exception of Hungary. In contrast to the dynamic growth recorded in the other nine countries, Hungary's higher rate of growth had slowed substantially by 2007 and living standards, measured in terms of per capita GDP, have stagnated since joining the EU. Though practically impossible to repeat in the near future, on the whole the region has developed at a pace rarely seen in economic history, accelerating the pace of convergence. This also means that almost upon the date of EU entry, the homogeneity of the Visegrád-group countries regarding their development path had ceased. The impact of these adverse developments was clearly visible in international comparisons and increasingly points towards a long-term trend that may be difficult to reverse.

From the perspective of growth and convergence based on both internal (investments, consumption) and external (capital flows, trade) factors, the new Member States who have so far coped better with the crisis are those that, since accession, have produced high but not overheated growth coupled with an appropriate level of external and internal financial stability, low budget deficits and a healthy public debt indicator. In the case of Poland an additional factor prevented a larger downturn. In other countries in the wider Central European region, credit based consumption and investment was more widespread than in Poland where financial deepening was slower. In other states where credit was the most important factor increasing demand, the sudden halt in the financial markets resulted in a demand shock. In other words, over consumption had to be adjusted to the available income. This shock was much bigger in other countries than in Poland.

The economies in the Central European region should formulate a new economic strategy under the new domestic and international conditions. This strategy is different from the previous one in two respects. First, achieving fiscal balance has become a number one priority. Second, growth should be far more firmly based on savings than easy credit. Due to the lack of uniformity in starting points, these changes are affecting the region's countries differently. But the principal emphasis of the "new" economic policy points in these two directions.

The depth of the crisis over the past two years has required significant adjustment from all of the Central and East European countries. This either means improving their budget position or their external equilibrium. In all cases, however, this goes hand-in-hand with a decline in economic output and a rise in unemployment. The potential for achieving stabilization essentially depends on how the international funding situation pans out. A protracted crisis will trigger structural reforms and significant adjustments more quickly in countries that, from a long-term economic development perspective, are in a worse position. This is why the conditions for long-term growth may turn out favourably in the most strongly affected countries – assuming they follow suitable economic policies. This may nonetheless have severe social consequences in the Baltic States. However, this cannot be excluded in the Visegrád countries either.

The expectation for the post accession period was that the need to comply with the Maastricht criteria would push the Central European countries to decrease economic disparities between their countries and the former EU Member States. The indirect harmonisation of economic policies was supposed to be a tool to support convergence across their economies. Independently from economic policy coordination, outside pressures in the longer run indirectly help some convergence of economic policies between the Visegrád countries. This coordination has been almost non-existent during the past two decades and only serious economic security policy threats could alter the situation. Currently, this is exactly the case. However the developments in the region hint that the tools chosen by the regions' countries are again different and the dividing line is again between Hungary and the others.

In Hungary, at the moment, the visible government aim is to stabilise public finances by raising revenues from additional sectoral taxes: channelling private savings from the pension system into the budget and at the same time cutting income taxes both for households and the corporate sector. In the short run, due to these steps the Hungarian budget position will be stabilized, but the longer term consequences are so far not evident. The sustainability of public finances and also the transfer system (pensions, social transfers etc.) is questionable after 2012-2013. Revenue-side stabilisations have rarely been successful over the past 15-20 years in Europe. The more common form of stabilisation efforts pursued in Europe, followed as well by other Visegrád countries, is based far more on the spending side. This difference clarifies that the future budget position and debt risk in Hungary and in the other three Visegrád countries is currently judged differently by international actors. However, Hungary is also now more and more strongly forced to introduce severe cuts on the spending side. Moody's placement of Hungary' sovereign debt in the Baa3 category clearly reflects this risk. The Czech and Slovak ratings are A1 and the Polish rating A2. There is one more difference that is the changing foreign policy priority in Hungary the aim of which is to strengthen economic relations with China.

One interesting feature for each of the Visegrád countries is the changing international strategies of global firms. Many firms are forced to search for further cost-cutting in order to regain their competitiveness in face of an economic environment where demand in several sectors is expected to stabilise at lower levels than before the crisis. In such circumstances firms are eagerly looking for cost-saving measures that, in large firms, may result in rethinking their global presence, leading to the potential closing of high cost production facilities and their partial relocation to lower cost countries. As big multinationals in some cases are deterred from closing facilities in their home countries (for example due to government warnings, e.g. in some major Western European countries), they may choose to downsize production in other high wage countries. Visegrád countries are low cost locations and the facilities in some sectors (the car industry for example) are technologically modern and very competitive. Thus they can expect some additional investment as part of multinational global cost-optimization strategies. It is no accident that, in Hungary, we have witnessed several additional investments from big car makers in recent months while the future prospects for economic growth and fiscal stability are still not very bright. And this phenomenon is very promising, as it illustrates that Central European countries remain attractive locations in international comparison. This may be an additional factor in maintaining export-oriented growth in Hungary, Slovakia and to some extent in the Czech Republic. Poland stands out somewhat from the region as the size of its domestic market makes reliance on domestic demand possible, instead of the external strategy that is the major growth component in the other three countries of the region.

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