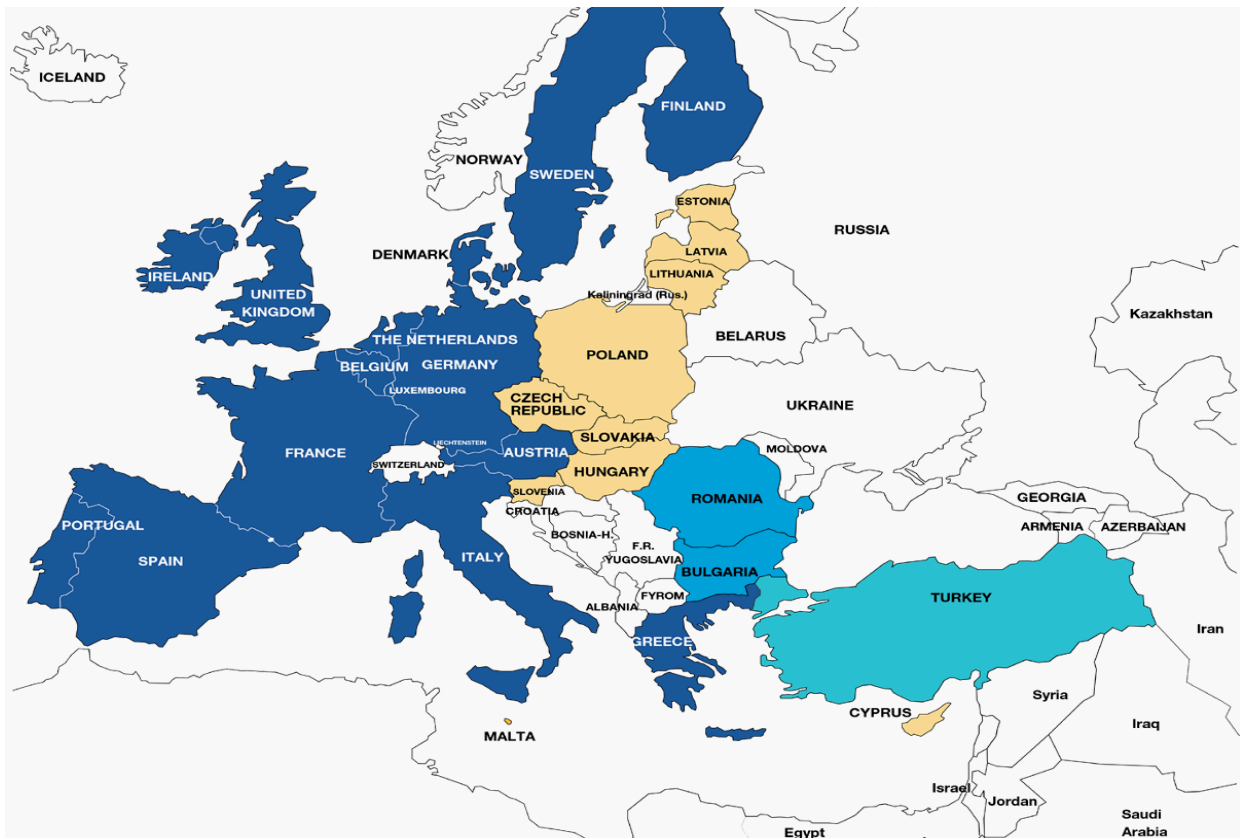


EU Revision – Economic Challenges facing Eastern Europe in 2009



The EU single market has enlarged on several occasions – the most recent being 2004 (ten new countries) and 2007 (two new countries). For many countries of ‘New Europe’ the accession into the EU has been an event of major economic and political importance.

Enlargement occurred during a period of strong economic growth (driven by fast-growing exports in an era of globalisation) and low inflation and interest rates. One can argue that this was an opportune time to widen the single market – macroeconomic conditions were favourable.

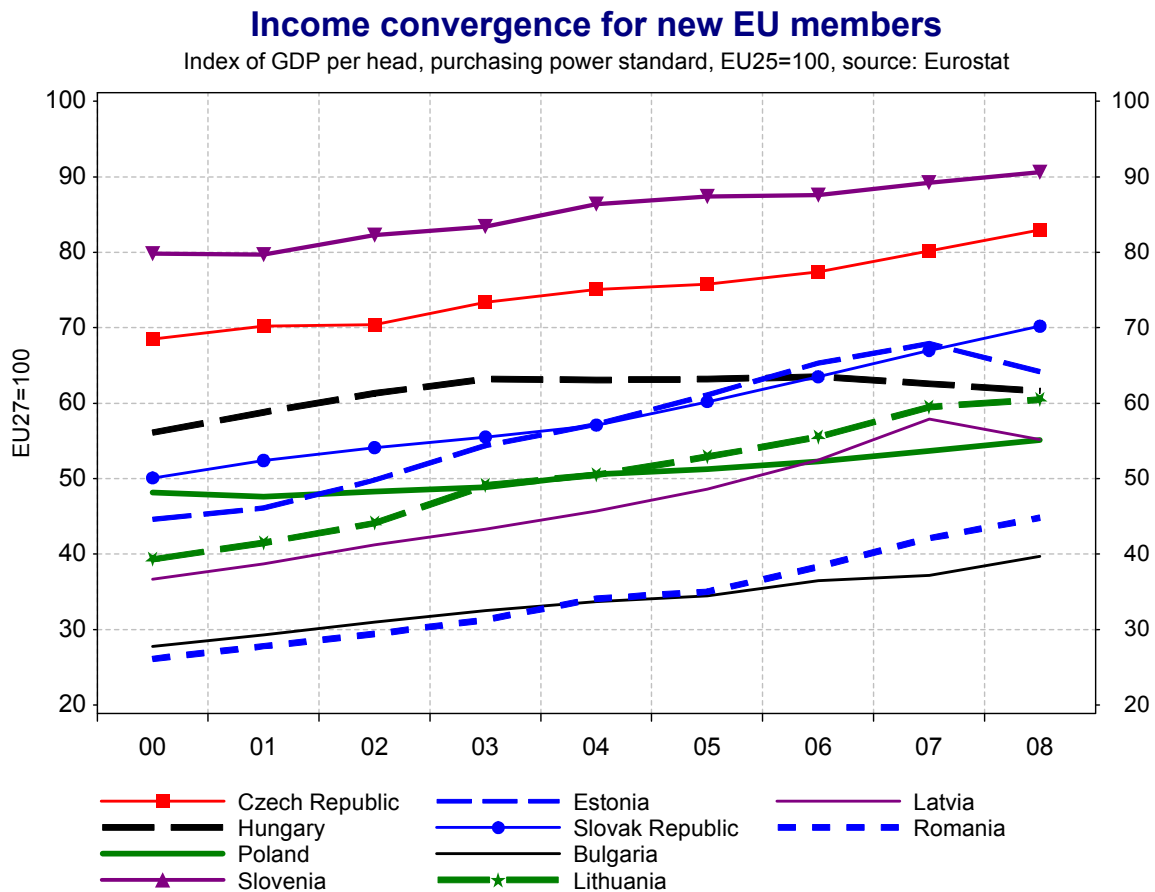
But progress made by new EU members has not been even – most have achieved a degree of **income convergence** and have managed to bring down **unemployment levels**. But there have also been underlying problems – notably **property bubbles**, **rising inflation** and the effects of **depopulation** as migrant workers from central and eastern European countries in particular moved west in search of work and higher incomes.

From late 2007 onwards the global credit crunch and ensuing international slowdown and recession has hit the EU hard. The Euro Area is **export dependent** (more so than the USA) and economic and financial difficulties have spread into many of the new member states.

Recap on some of the benefits of EU membership

1. Trade creation effects – many countries of New Europe export > 50% of their products to Western Europe
2. Encouragement for FDI inflows – boosting employment, real wages and productivity
3. Prospect of Euro membership and a greater degree of macroeconomic stability
4. Farm and Regional Policy payments
5. Funding for transport & environmental projects
6. Opportunity for convergence of relative living standards

As the chart below shows – there has been notable progress in income convergence between new EU countries and the EU27 average per capita incomes



Economic difficulties facing eastern European members of the EU

1. Deep recession –
 - a. This is the first major downturn since the post-communist chaos of the early 1990s
 - b. The worst-affected countries will be those dependent on the Euro Area for investment and export markets e.g. in 2007 Czech Republic sent 52.6% of its exports to the EU-27, with the equivalent figure being 50.4% in Hungary and 53.5% in Poland.
 - c. Good example is the collapse in demand and production in the European car industry
2. Rising unemployment added to by the return of migrants from countries such as UK
3. Huge government debts - fuelled by the recession but also by longer term factors such as an ageing population
4. Asset price deflation after property bubbles burst e.g. Latvia, Estonia and Lithuania
5. Many of their currencies are depreciating - making it harder to service debt issued in Euros - Some currencies have come under speculative attack
6. Banking system suffering from high level of bad debts - many western Banks are heavily exposed – is this Europe's own sub-prime crisis?
7. Loss of investor confidence in central and eastern Europe – some reversal of FDI flows – which have been a major source of growth over recent years

Implications for the UK economy

1. In the short term – a fall in exports
2. Some UK firms will cut back on their FDI into central and Eastern Europe
3. Recession may limit the extent to which eastern European migrants head back home

Evaluation points

1. Long term process of convergence with Western Europe was never going to be smooth – the key is how the new EU members respond to the challenge especially on the supply-side of their economies
2. Some new EU members suffered from unsustainable booms (e.g. the Baltic States) but the same happened in Spain and Ireland and they have much higher levels of private sector debt
3. Several countries including Poland, the Czech Republic, Slovakia and Slovenia are out-performing the UK and others during the international crisis
4. Eastern European region's medium term key competitive advantages remain – especially low-cost high-skill labour – attractive to manufacturing businesses
5. The 2009 crisis may persuade CEEC countries to reduce their dependence on foreign direct investments, foreign borrowing and additional funds from Brussels and build an economic growth model on different grounds