Special
EU Enlargement @ 10

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Raiffeisen RESEARCH

A success story, but no free lunch

- 2004 EU enlargement added substantially to overall EU competitiveness, e.g. via "German-CE supply chain" cluster
- CE contributes significantly to EU world market export share, with a relative contribution well above its GDP share
- Some past growth drivers partially exhausted, future (income) convergence path to be shallower
- High through-the-cycle resilience in Poland, Czech Republic and Slovakia supports solid medium-term growth outlook

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Share EU GDP at enlargement (%)

Greece (1981)	1.6
Spain, Portugal (1986)	6.9
Austria, Finland, Sweden (1995)	6.7
CE (2004)*	4.2
2004 Enlargement round **	4.8

** CE: PL, HU, CZ, SK, SI*
*** CE + Baltics + Cyprus + Malta*
Source: IMF, Eurostat, Raiffeisen RESEARCH

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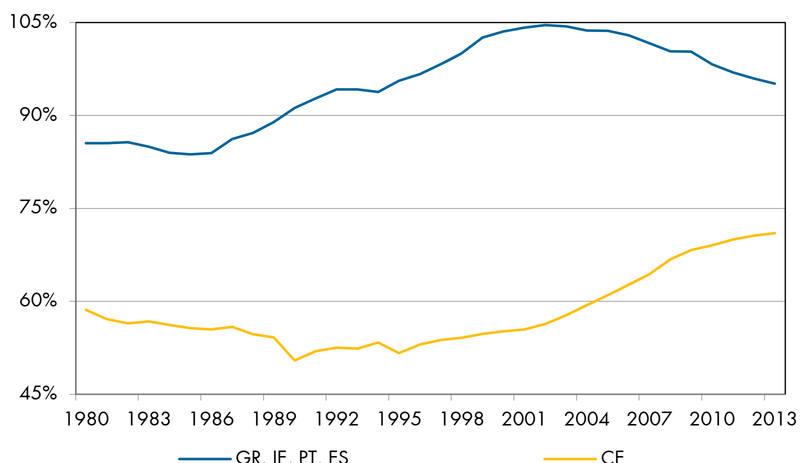
Introduction

Some ten years ago, in May 2004, ten countries joined the EU: Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovakia and Slovenia. In terms of number of new member countries and people this was the largest single enlargement round in the history of EU. In economic terms, i.e. in terms of additional nominal GDP in EUR-terms, there were definitely larger EU enlargement rounds compared to the one of 2004. Back in 2004 the overall enlargement round (ten countries) added just some 4.8% to the EU GDP. The bulk out of this 4.8% in GDP gains for the EU, i.e. 4.2%, came from the five Central European (CE) economies of Poland, Czech Republic, Hungary, Slovakia and Slovenia. Just for comparison: The previous two larger EU enlargement rounds (Spain, Portugal in 1986; Austria, Finland, Sweden in 1995) both added 6-7% to the EU GDP. The fact that the 2004 enlargement round was not one of the biggest in GDP terms does not mean that it was not a successful and important one in economic terms. This holds especially true for the five CE countries that joined the EU in 2004. The following analysis will focus on the experience of the new (2004) EU members from CE with European economic and financial integration.

The CE share in the overall EU GDP rose from 4.2% back in 2004 to 5.7% in 2013, which represents a relative increase by 35%. Therefore, in economic terms and on average the five CE countries had been more successful compared

GDP per capita at PPP (% of EU average, current international dollar)



Source: Eurostat, IMF, Raiffeisen RESEARCH

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Share in EU GDP (%)

	2004	2013	Change (%)
Greece	1.7	1.39	-20.1%
Spain, Portugal	9.3	9.09	-2.3%
Austria, Finland, Sweden	6.4	7.08	11.3%
CE *	4.2	5.70	35.7%
2004 Enlargement round **	4.9	6.47	32.9%

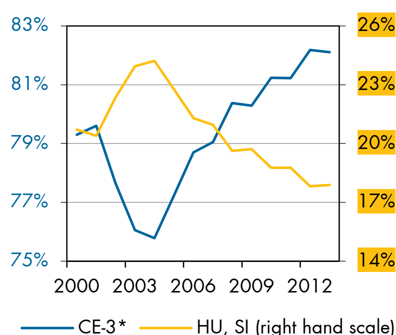
** CE: PL, HU, CZ, SK, SI*
*** CE + Baltics + Cyprus + Malta*
Source: IMF, Eurostat, Raiffeisen RESEARCH

CE contribution to EU, several indicators (%)

	2004	2013
GDP	4.2	5.7
FDI	5.0	6.9*
World market export share	6.2	9.7
Banking assets	1.7	2.2

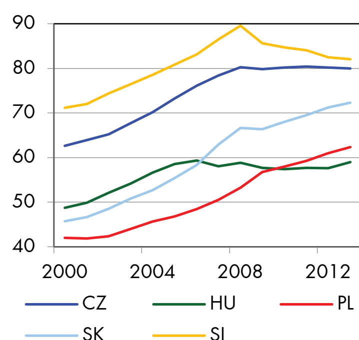
** 2012 value*
Source: Eurostat, ECB, national sources, UNCTAD, Raiffeisen RESEARCH

CE: Regional GDP share trends**



** CE-3: PL, CZ, SK*
*** Share in regional GDP, based on nominal GDP figures in EUR-terms*
Source: Eurostat, national sources, Raiffeisen RESEARCH

CE: GDP per capita at PPP*



** in % of euro area average, current international dollar*
Source: IMF, Raiffeisen RESEARCH

to other EU countries being part of former EU enlargement rounds. Moreover, nearly all EU economies in CE are greatly integrated into the EU economic organization nowadays as can be shown by their high degree of trade openness (mostly intra-EU trade) and FDI penetration. Therefore, CE exploited the advantages European economic integration offers in a very effective way. In fact the CE countries are part of the so-called "German-CE supply chain" cluster (GCESC). It goes without saying that the strong integration of the CE region with the German economy and other countries of the so-called "core" euro area (like Austria, see page 3), which also reflects a changing division of labor within the enlarged EU, significantly adds to the overall competitiveness position of the EU.

The long-term economic success of the converging CE economies becomes even more outstanding in the context of the most recent setbacks that are characterizing several Western European catching-up EU economies. Since 2004 the average GDP per capita (at PPP) in CE compared to the EU average increased by 12 pp, while it decreased by 9 pp in "former" Western European catching-up economies like Spain, Portugal, Ireland or Greece. Other indicators like low unemployment rates, solid public debt positions, fairly stable sovereign ratings or solid banking sector developments also confirm the high degree of through-the-cycle resilience in major CE economies, which is also a confirmation of the past quality of growth. Therefore, it is no surprise that financial markets are pricing most CE countries fairly close to "core" euro area countries. This holds true regardless of whether euro area membership has been already achieved or not. That said the tenth anniversary of the EU expansion to CE should result in a shelving of the past thinking in terms of an "East-West"-divide inside the EU. However, at this juncture it has to be stressed that the overall CE success story also has its weak spots. In Hungary economic convergence has more or less stalled since a decade (despite a highly competitive export sector). Slovenia embarked on a boom-bust cycle (fostered by very early euro area membership) that comes close to boom-bust patterns seen in peripheral euro area countries like Spain. However, this should not play down the successes seen in the other three CE countries, which account for about 80% of the regional GDP! Nevertheless, past success is no guarantee for future economic success. Some easy drivers of economic growth are largely exhausted in CE, which makes it harder to grow much faster than the most competitive Western European economies. Therefore, future income convergence in CE (either taking the EU average or Germany as a point of reference) is likely to be much shallower than over the last decade.

Finally, it has to be added that the success of the CE countries with EU economic integration was framed by a very unique global and European economic background (i.e. major deepening of the EU internal market, integration of global emerging markets into the world economy, strong global FDI and financial liberalization). Hence, a repeat of the CE success story in other countries and regions (besides other factors) would not be a tranquil enterprise.

Real convergence: GDP per capita trends in CE

In terms of real convergence (i.e. output and income convergence measured as GDP per capita) CE narrowed the gap to more advanced EU economies, i.e. to the euro area average substantially, over the last decade. The starting point of the respective CE countries has been rather heterogeneous. Prior to the 2004 EU enlargement, Slovenia and the Czech Republic had the highest GDP per capita levels (at purchasing power parities). In relation to the euro area, these countries started at a level of 75% and 65%, respectively. Hungary and Slovakia followed with some 50%; while more populous Poland was trailing at 40% of average euro area GDP.

In the years immediately following EU accession, the CE countries made a big leap forward. In the Czech Republic, Slovakia and Slovenia output per capita increased by more than 10 pp towards the euro area average. In Hungary and Poland the progress was less pronounced but with a plus of 6-7 pp still significant as well. Strong real convergence has been fuelled partly by successful export performance, but also by strong growth in domestic demand, brisk bank lending and quickly rising average wages in several countries. This also led to the emergence of external imbalances, i.e. growing current account deficits, as well as certain overheating in the financial sector. The overheating corrected swiftly in the context of the global financial crisis in 2008/09. The rapid adjustment of external imbalances was largely based on the strong export capacities in CE, coupled with substantial drops in domestic demand (and hence imports).

As the 2008/09 global crisis has been rather a watershed for CE, it comes as no surprise that the pre-crisis growth trajectory in CE (e.g. from 2006-2008) differs substantially from the post-crisis environment. A clear cut intra-regional distinction regarding the convergence process emerged, with convergence slowing down in the Czech Republic, Hungary and Slovenia, while it continued in Poland and Slovakia. This relates to the extent of pre-crisis imbalances, overall macroeconomic

Focus on: Austria's specific role as significant regional investor

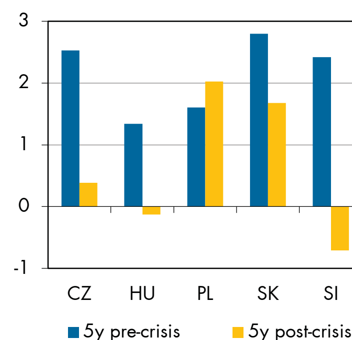
The engagement of the Austrian economy in CE is at fairly high levels in the real economy as well as in the financial sector. The substantial linkages of Austria to the CE region can be shown in the relative shares in trade turnover. In the Czech Republic, Slovakia, Hungary and Slovenia Austria is among the top 3 to 7 players in terms of export and import turnover. Only in case of Poland, Austria is not among the top ten foreign trading partner countries (here Austria takes the ranks 12-15 on the export and import side). In the whole CE region foreign trade with Austria represents around 4% of total trading volumes, while Germany dominates here with trading volume of around 25% (i.e. German trade exposure to CE is around six or seven times larger than the Austrian one). In the CE region (excl. Poland) the Austrian share in foreign trade is at some 7%, compared to a Germany share in foreign trade of some 22%. Therefore, in relative terms the German share in overall foreign trade in CE (excl. Poland) is just some 3 times higher here than the one of Austria. For comparison: the German share in EU world market exports is around ten times higher than the one of Austria (only in case of Poland Germany's trade exposure is well above the regional average representing something like twelve times the Austrian trade volumes). This shows the relative strong gearing of Austrian trade exposures to CE (although Germany itself remains the by far most important trading partner of Austria).

In absolute terms the Austrian economy is one of the biggest investors in the region CEE and the CE countries in particular. Austria represents some 13% of the FDI of Western European countries in CE, while the share of Germany stands at "just" 20%. Given the very different size of the Austrian and Germany economy the relatively high gearing of Austrian FDI into this region becomes evident. Here it has to be stressed that large parts of the Austrian FDI in the CE region also represent banking sector engagements (i.e. majority equity positions in large local banks). Like with trade linkages Austrian investment activity is concentrated in the neighboring CE countries, i.e. the Czech Republic, Slovakia, Hungary and Slovenia. In the Czech Republic, Slovakia and Slovenia FDI with Austrian origin are at least at the level of German FDI or even above that. On the Polish market the Austrian share in the overall FDI stock is well below the regional CE average. Therefore, the relative distance to the German FDI footprint in Poland is also higher than in some other CE countries (the German economy also has a very high gearing towards Hungary with a total of around 40% of the Hungarian FDI stock).

In the banking sector the relative position of Austria is even much stronger than in the real economy. In absolute terms the engagement of Austrian banks in CE is higher than the one of German banks. Austrian banks represent something like 20% of total banking exposures of Western banks to the CE region, while exposure by German banks represents "just" around 14% of banking exposures of Western banks to CE. Austrian banking exposures to CE are also larger than the ones of other banking sectors with leading Western European CEE banks, as French and Italian CE exposures are also below 20% of total banking exposures of Western European banks to CE.

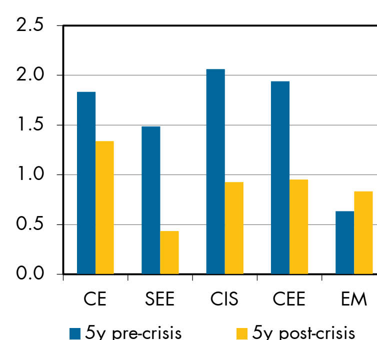
Financial analyst: Gunter Deuber

CE: Convergence rate to EA*



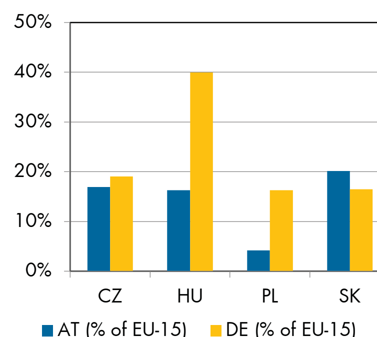
** change GDP per capita at PPP (pp per year), 5 year periods from 2001/2003 to 2006/2008 ("pre-crisis"); and from 2006/2008 to 2011-2013 ("post crisis")*
Source: IMF, Raiffeisen RESEARCH

CEE: Convergence rate to EA*



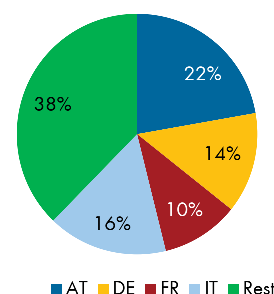
** change GDP per capita at PPP (pp per year), 5 year periods from 2001/2003 to 2006/2008 ("pre-crisis"); and from 2006/2008 to 2011-2013 ("post crisis")*
Source: IMF, Raiffeisen RESEARCH

CE: Inward FDI stock (% of EU-15 FDI)



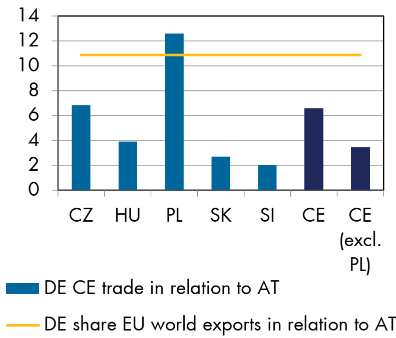
** 2012 data*
Source: wiiw, national sources, Raiffeisen RESEARCH

CE: Regional banking exposures*



** % of Western European BIS-reporting banks, 2013*
Source: BIS, Raiffeisen RESEARCH

CE: DE & AT relation trade turnover*



* The share of the German economy in EU world market exports is around ten times higher than the one of the Austrian economy; in CE German trade turnover is "just" 6 times higher than Austria's trade turnover
Source: wiiw, national sources, Raiffeisen RESEARCH

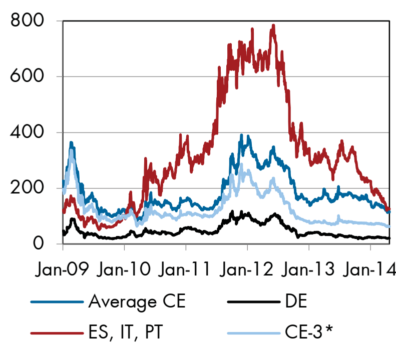
GDP per capita gains vs. DE (pp)

	First 10 years EU membership	2007-2013
GR, IE, PT, ES	9.8%	-11.5%
CE	5.5%	1.4%

GDP per capita gains vs. EU (pp)

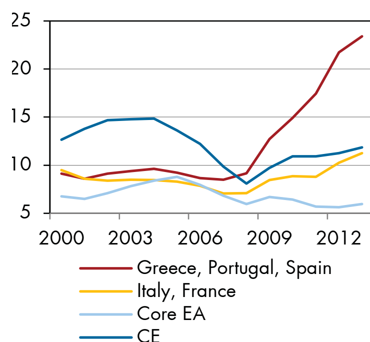
	First 10 years EU membership	2007-2013
GR, IE, PT, ES	12.8%	-6.5%
CE	11.6%	6.6%

5y CDS (bp)



* CE-3: PL; CZ, SK
Source: Bloomberg, Raiffeisen RESEARCH

Unemployment rates (%)



Source: Eurostat, national sources, Raiffeisen RESEARCH

Focus on: CE vs. other EU convergence economies

At this juncture it has to be stressed that on average the CE economies represent fairly successful EU convergence economies. This holds especially true from a so-called through-the-cycle perspective. That said relative income convergence (measured as GDP per capita at PPP either compared to the EU average or Germany) continued in CE, while income convergence in "former" EU convergence economies clearly reversed in recent years. That said it comes as no surprise that the CE region on average also fares relatively well in terms of additional social costs (e.g. via rising unemployment or strongly increasing public debt levels) induced by the global financial and euro area crisis. This can be shown by the levels of unemployment rates and the relative rise in unemployment rates in particular. The same holds true for public debt levels and the relative rise in public debt-to-GDP ratios (although Slovenia is a clear outlier here).

As shown throughout the report the relative resilience of the CE region is largely based on a successful economic integration into the EU economy and indirectly (via strong trade links with Germany) the world economy. Hence, the solid position of the CE economies compared to other EU convergence economies or EU economies with international competitiveness issues can be well shown by the relative shares in EU GDP and EU world market exports. The CE region represents 9.7% of the overall EU world market export share, while the CE share in the overall EU GDP stands at some 5.7%. It goes without saying that Germany is also characterized by a share in EU world market exports that is well above its GDP weight within the EU (26.8% share in EU world market exports vs. 20.9% share in EU GDP). The (former) EU convergence economies of Spain, Portugal and Greece together represent just 7% of the EU share in world market exports, compared to a GDP weight in the EU of 10%. France and Italy are characterized by similar relationships, i.e. a share in EU world market exports that is well below their respective share in the overall EU GDP.

The solid position of the CE region – with some distance still prevailing to the "core" euro area in terms of income levels or unemployment rates – is well reflected in relative stable country ratings. Currently the CE region has an average rating at A- (S&P scale and ratings). This is just one notch below the up to now highest average CE rating achieved back in 2006 at the level of A. In contrast S&P currently assigns an average rating of BBB- to the (former) EU convergence economies of Spain, Portugal plus Italy, which is around 3 notches below the average CE rating. That said the relative rating position of the CE region compared to Spain, Portugal and Italy experienced a drastic reversal over the last decade. Back in 2004 the average CE rating was still 4 notches below the average rating of Spain, Portugal and Italy, while nowadays there is a positive rating gap by three notches (i.e. the relative change over the last decade amounts to 7 rating notches). The average CE rating definitely suffers from rating setbacks in Hungary and Slovenia seen over the last few years. The average rating of the Czech Republic, Slovakia and Poland would be at a level of A, which would be four notches above the average rating of Spain, Portugal and Italy. Therefore, financial markets are currently pricing Czech Republic, Slovakia and Poland well in the middle between the "core" euro area benchmark Germany and the so-called euro area periphery.

Financial analyst: Gunter Deuber

vulnerabilities and the ability to deal with the financial crisis as well and euro area double-dip recession in 2009 and 2012/13. Moreover, previously less successful countries like Poland and Slovakia might have had still more easily attainable catch-up potential. Thus, GDP per capita in Czech Republic in terms of the euro area average did stagnate more recently, while Hungary and Slovenia witnessed a tangible setback. In case of Slovenia this happened at a fairly high income level, while Hungary became the "poorest" CE country (GDP per capita below 60% of the euro area average). In Slovenia, a bust of the domestic real estate and banking sector is still weighing on the country's economy, while in case of Hungary, politics had to manage the remnants of earlier spending excesses, high public debt and continued weak domestic demand (in sharp contrast to a successful export sector). Poland and Slovakia were able to continue to boost GDP per capita over the last five years. In case of Poland this even implied acceleration in the convergence process, facilitated by a successful management of the financial crisis and the fact that Poland did not enter recession in 2009.

Divergent developments in CE in recent years show that EU accession is (1) no automatic lift to prosperity as countries may take different development paths and

(2) that income gains may be even reversed, i.e. real convergence is no one way street. Nevertheless, in general, the CE countries performed well in comparison to other CEE countries over the last ten years. The SEE and CIS countries are characterised by a less successful and convergence process showing a much lower through-the-cycle resilience.

CE: International economic integration

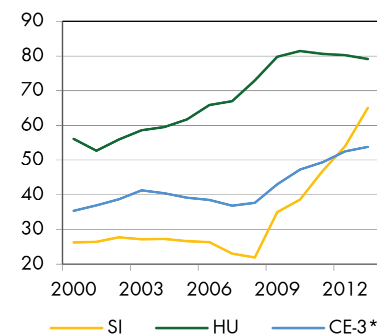
The CE countries covered in this report are characterized by a very high degree of international economic integration – which here means in fact EU integration. This holds true for several indicators of international economic integration that are also implicitly measuring the quality of economic integration. All CE countries show an increasing trade turnover (i.e. the sum of goods & services exports and imports) in particular with the EU since the mid-nineties. This development has also been intertwined with the a rise in FDI in manufacturing capabilities.

Structurally, the EU is the main trade partner of CE, with a share in total exports of around 80-85% directed to the common market. The deepening trade relations of CE are often also a part of international supply chains with Western Europe and the Germany's globally oriented "export machine" in particular (see also the Focus on section on the so-called "German-CE supply chain" cluster on p. 7). As the IMF points out, the export share of 20-30% to Germany shown in traditional statistics is overstating the role of German final demand for CE. Many export goods from CE are intermediate goods, which are used in German exports to the world economy. Thus the share of true final demand from Germany is likely lower at around 15-20% of total exports of CE countries. This has the implication that CE economies are less vulnerable to the German domestic business cycle, but more attached to the dynamics of German exports, which to a large degree are governed by the outlook for the world economy and to some degree by global emerging market trends.

Besides Poland, which in itself has a fairly sizable domestic market, the CE countries can be seen as typical representatives of small open economies. Thus their trade to GDP level has been traditionally high and above the EU average. Already in the second half of the 1990ies, the trade-to-GDP ratio of CE (excl. Poland) amounted to 100-120% of GDP and the export-to-GDP ratio to 50-57%. For Poland the respective ratios in this period have been lower at 50% and 23% of GDP respectively, which is comparable to the openness of larger EU economies like Germany, Italy or France at that time. Nevertheless, in the run-up to EU accession, average trade and export ratios in CE (including Poland) made a jump, increasing by 18 pp and 9 pp of GDP (from the averaged five year period 1995-1999 to 2000-2004). This might be an indication that domestic and foreign businesses were already anticipating the accession to the large internal EU market and preparing for the entry by actively developing trade relations.

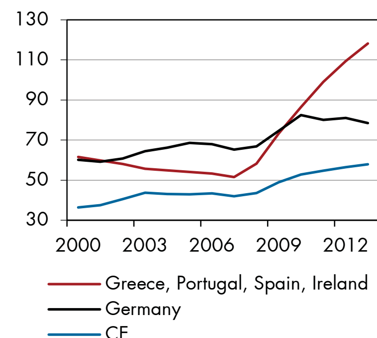
In the years around and directly after the 2004 EU accession the opening up of the CE economies continued. In the following five year period (2005-

CE: Public debt (% of GDP)



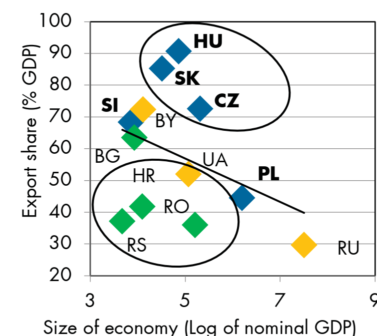
* CE-3: PL; CZ, SK
Source: Eurostat, national sources, Raiffeisen RESEARCH

Public debt (% of GDP)



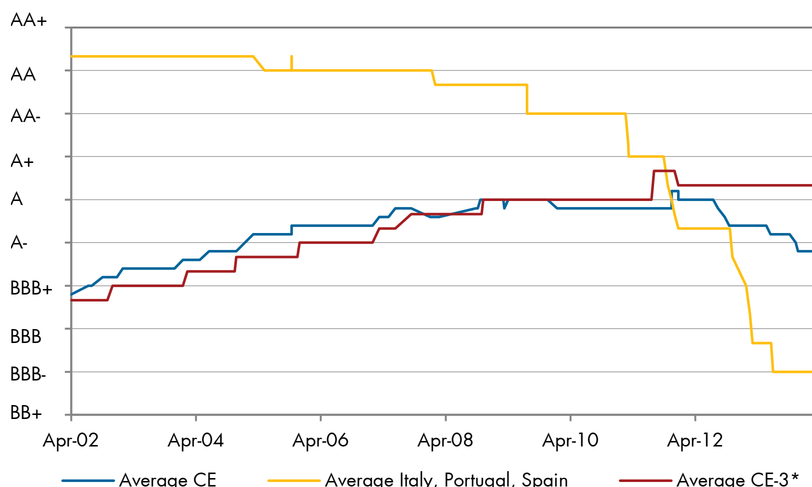
Source: Eurostat, national sources, Raiffeisen RESEARCH

CE: Small open economies*



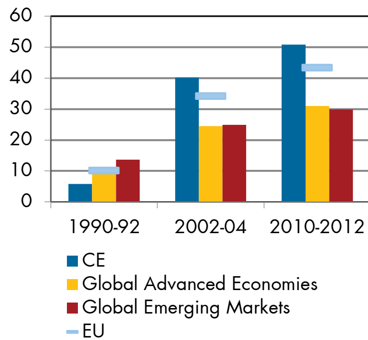
* *average of 2010 to 2011/2012; Source: Thomson Reuters, World Bank WDI, Raiffeisen RESEARCH*

Long-term sovereign rating trends**



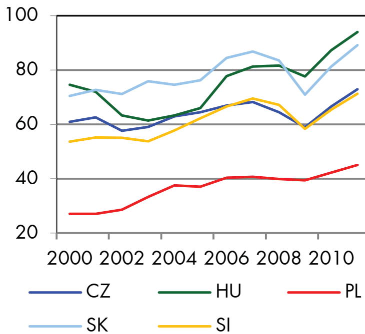
* *CE-3: PL; CZ, SK*
** *Average S&P sovereign rating, not GDP weighted, latest data point April 2014*
Source: S&P, Bloomberg, Raiffeisen RESEARCH

Inward FDI stock (% of GDP)



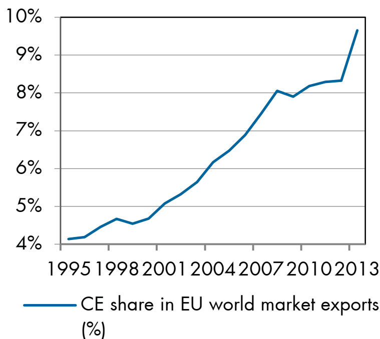
Source: UNCTAD, IMF, Raiffeisen RESEARCH

CE: Export of goods & services*



* *% of GDP*
Source: Thomson Reuters, World Bank

CE: World market export shares trend

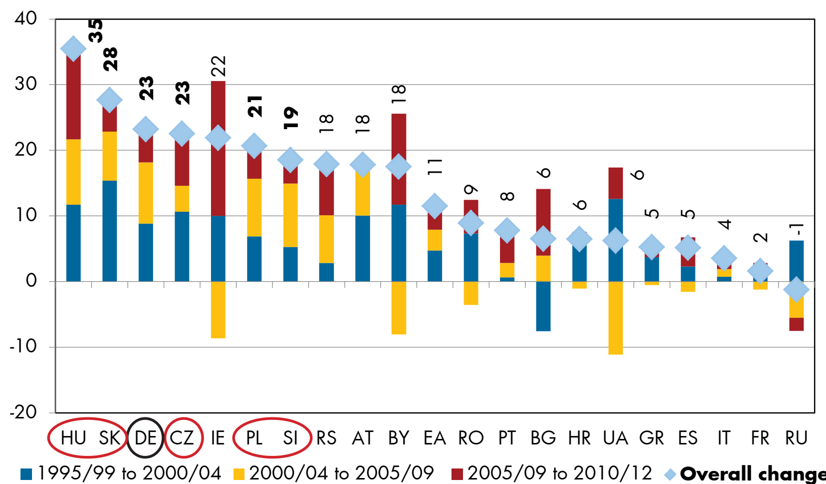


Source: Eurostat, Raiffeisen RESEARCH

2009), the ratio of trade-to-GDP increased by further 13 pp and exports by additional 8 pp of GDP on average, reaching 55% in exports and 110% in total trade (again including Poland). This move was paralleled by a significant rise in the importance of exports and trade for the German economy, the largest EU economy. Germany's, trade turnover rose in the decade from the late nineties to the second half of the 2000ies from 50% to 85%, exports increased from 25% to 45% of GDP. The CE and German experience is contrasted by developments of other countries in- and outside the EU, which underlines the specific path of CE. For example, SEE countries continued to retain much smaller export sectors. The same is true for the Southern countries inside the EU, i.e. the countries which later became victims of the euro area crisis. Exports ratios of Spain, Portugal and Greece, but also Italy and France remained fairly unchanged over the last decade at ~20-30% of GDP. With respect to CE (and Germany) the global financial crisis and great recession in 2008/09 did not significantly slow down (or reverse) the process of further deepening trade integration, as trade openness and export shares continued to rise. However, given weak domestic demand post-crisis in most CE countries and overall slower GDP growth, the most recent rise in trade openness ratios might overstate the underlying development. This holds especially true for the overall economic momentum (including domestic demand). In sum, the average openness to trade in CE over the last 15 years (i.e. including the years ahead of EU accession) increased tremendously from 80% to 120%, the export-to-GDP ratio from 40% to 60%. Heterogeneity on a country level remained, with Poland at the lower end (90% trade and 45% exports), while the numbers for the other CE countries now range between 140% (CZ) and 175% (HU) for trade in relation to GDP.

As a second dimension of economic integration, the high inward FDI flows and stocks in CE had been an important source for technology and skills transfer, while they also added to competition on the domestic market. The very successful integration of CE into the international division of labor via high and continuous FDI inflows (and hence increasing FDI stocks) already started well before formal EU membership in 2004. From a very low base with an FDI stock at 5% of GDP at the beginning of the 1990ies (10% of GDP was the EU average at that time), the inward FDI stock in CE increased to 40% of GDP up until the years 2002-2004 (34% average inside the EU). The strongly increasing FDI penetration in CE already well before the EU entry in 2004 seems highly rational as anticipation effects of EU membership and the idea to secure a "first mover" advantage made it highly attractive for companies to invest even before formal membership was achieved. It goes without saying that the effect of strongly increasing FDIs can be largely attributed to the EU membership. FDI stocks inside the EU tend to be much higher than in comparable non-EU countries; FDI stocks in emerging EU countries tend to be much higher than in emerging markets in general.

Cumulative change in exports since the mid-90ies (pp of country GDP)



Source: Thomson Reuters, World Bank, Raiffeisen RESEARCH

Nowadays the average FDI stock in CE stands at 50% of GDP, compared to a reading of 43% inside the EU. Poland (due to the larger country size) and Slovenia (due to past less active FDI policies) are characterized by inward FDI stocks below the regional

Focus on: The "German-CE supply chain" cluster

As already shown in this report Germany has deep FDI and trade linkages with the CE region. These linkages are a reflection of the fact, that German economic growth since 1999 up until 2009 was largely driven by exports and imports of parts and components (which also explains the term "bazaar economy" introduced during that period of time). The resulting so called "German-CE supply chain" cluster or GCESC – named by the IMF – with a significance beyond pure trade figures has several important implications for Europe, Germany and CE. Firstly, the existence of the GCESC cluster clearly shows that the very high degree of international competitiveness of the German economy is based on a significant "helping hand" in CE (also reflected in the fact that trade in intermediate goods between Germany and CE expanded much stronger than trade in final goods). The existence of the GCESC also reflects the changing division of labor within the enlarged EU (i.e. supply chains are increasingly established beyond national borders and on a regional level). Secondly, the GCESC offers substantial economic upside for the CE region. However, the limitations resulting from this fairly special economic integration have to be well understood as well.

The so-called GCESC represents the link of the CE region to world markets, because most trade between Germany and CE is in intermediate goods relevant for German exports. That said demand from outside of Western Europe is of higher importance for CE than domestic demand in Germany (and Western Europe). However, it has to be acknowledged that Germany has a very specific niche on world markets, specialized in a unique mix of quality and price leadership in so-called "medium-tech technologies" (not per se high-tech). The latter coupled with aspects like geographical proximity to CE, some structural similarities to the German economy in CE, cost-competitiveness and high education standards, was a driving force behind the substantial German FDI in CE. For instance in several CE economies there is also something like the "German Mittelstand" and several CE countries had been the major suppliers of "medium-tech technologies" (like cars, machinery, train components etc.) in the socialist COMECON space. Therefore, the share of industry in GDP in CE was higher than in Southern EU countries of former enlargement rounds, which explains why CE attracted more German FDI than the Southern EU countries like Portugal, Spain or Greece. Most German FDI in CE also took the form of Greenfield investments, which usually represent a long-term commitment. That said for the next few years the GCESC is likely to remain highly relevant for the CE economies (and indirectly also for other countries like Austria, the Netherlands or Switzerland). And for the time being the GCESC offers the CE countries a significant economic upside, as global demand is expected to grow much faster than German or Western European final demand in the years to come. Large parts of the euro area are characterized by substantial deleveraging needs in the public and private sector for the years to come.

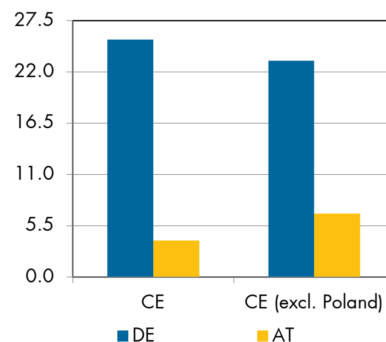
However, indirectly the GCESC exposes the CE countries to competitive pressure on world markets and other highly attractive manufacturing locations (which must not be per se other Western European economies). That said withstanding future pressure in terms of maintaining the specific mix of cost and quality competitiveness in CE will be key to maintain the positive effects of the GCESC. It should not be neglected that the German position of a high degree of international (cost) competitiveness is also based on long-term wage restraint. Moreover, the GCESC exposes CE to the business cycle volatility in Germany. The latter has material implications for the CE region as Germany is characterized by an above average business cycle volatility compared to other Western European economies or other advanced economies. This (indirect) exposure to a high degree macroeconomic volatility has to be factored in into CE economic policymaking.

Financial analyst: Gunter Deuber

Literature on the "German-CE supply chain" cluster:
Deutsche Bundesbank (2011): The Transmission and regional distribution of the German economy's cyclical impulses within Europe, Monthly Report March 2011, p.22-23
IMF (2013): German-Central European Supply Chain – Cluster Report, IMF Multi-Country Report, IMF Country Report No. 13/263, August 2013

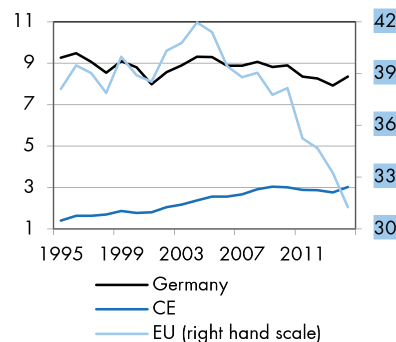
average. The Czech Republic, Slovakia and Hungary are characterized by inward FDI stocks at 55-70% of GDP. Here FDI stocks are well above the EU average and very close to levels prevailing in very competitive and open EU economies like the Netherlands or Belgium. With regards to CE it has to be stressed that the bulk of the FDI inflow went into productive investments in the tradable sector (and not into debt-creating creating investments and/or the non-tradable sector). Thus, the aggregated CE share in world market exports had been on a continuous and secular uptrend over the last decade. Since the year 2000 the share

CE: Shares in trade turnover*



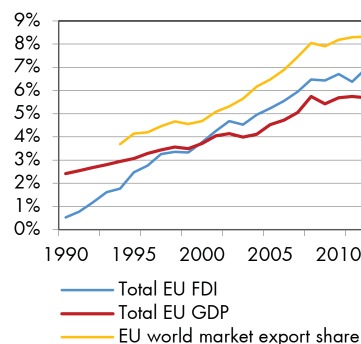
** % of total*
Source: wiiw, national sources, Raiffeisen RESEARCH

World market export shares(%)



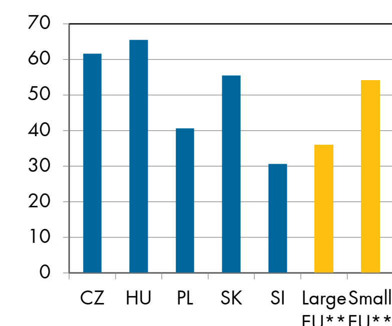
Source: Eurostat, Raiffeisen RESEARCH

CE: Share in ...



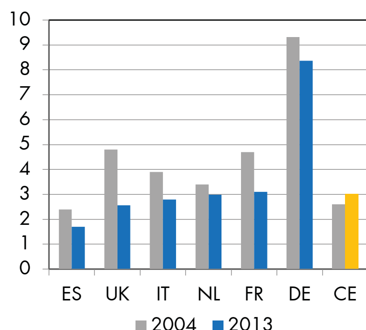
in % of total EU
Source: UNCTAD, Raiffeisen RESEARCH

CE: FDI in comparison*



** Inward FDI (% of GDP, avg. 2010-2012)*
*** Large EU: DE, FR, ES, IT; Small EU: BE, NL, SE, AT*
Source: UNCTAD, Raiffeisen RESEARCH

World market export shares (%)

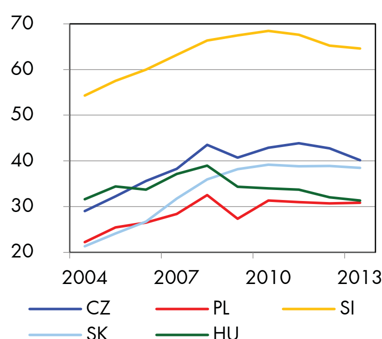


Source: Eurostat, Raiffeisen RESEARCH

of CE in world market exports increased from around 1.8% to 3% in 2013. In contrast to the uptrend in CE the overall EU share in world market exports decreased from 38.5% back in 2000 to some 31% in 2013. The only major EU country that was able to keep its world market share more or less constant over that period of time was Germany - with the help of CE countries as shown in this report – while nearly all other EU countries lost world market shares over the last decade or so. This holds also true for "core" euro area countries like the Netherlands or Austria or the highly competitive Swedish economy.

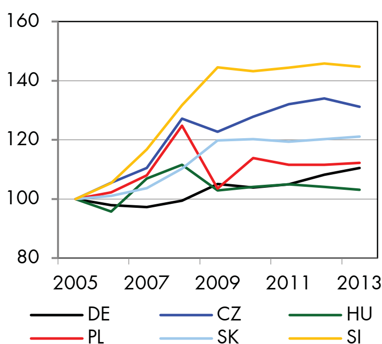
It has to be acknowledged that very high FDI stocks may also have some drawbacks that have to be taken into account. They may add to high intercompany loan stocks and also capital outflows (e.g. via dividends, royalties or fees if not reinvested). Therefore, high FDI stocks can add significantly to the external debt ratio, which in some cases may contribute to investor concerns (at least if just the headline external debt ratio in % of GDP is looked at). For instance the Polish economy is characterized by a fairly high external debt ratio, which is more a reflection of a high degree of international economic integration rather than a possible over-indebtedness (this aspect also partially explains why Poland has applied for the Flexible Credit Line at the IMF). That said high external debt ratios in CE have to be interpreted in a differentiated way. The productive use of foreign capital (external debt) in CE can be seen in the fairly positive relation of external debt to export capacity. Regarding this indicator the CE region clearly outperforms weaker EU (candidate) countries in SEE.

CE: Compensation of employees*



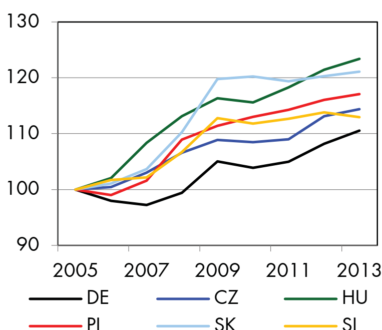
** in % of Germany, nominal, in EUR-terms, according to national account statistics, includes wages and salaries and employers' social contributions*
Source: European Commission, Raiffeisen RESEARCH

CE: Unit labour costs (in EUR-terms)*



** 2005 = 100*
Source: European Commission

CE: Unit labour costs (in LCY-terms)*



** 2005 = 100*
Source: European Commission

Focus on: CE competitiveness

Given the export-oriented economic model prevailing in the CE economies, the competitive position created by wage and productivity developments plays a decisive role for sustainability of economic growth. The initial cost position back in the nineties has been quite favourable (at least from the view of the employer). CE total compensation per employee (wages and social contributions) was at very low levels of around 10-15% of Germany. Until 2004, this measure of average labour costs had already grown considerably, but still remained between 20% and 30% of the German level, which translated into nominal labour costs of around EUR 600-900 per month. Only Poland fell back between 2001 and 20014 given a temporary weakness of the domestic economy. The big exemption to the upside is Slovenia, where income levels were much higher than in the rest of CE, already surpassing 50% of Germany in 2004.

In the first years after EU accession in 2004, the economic boom in CE countries supported further wage increases, reaching a highpoint in 2008. With the financial crisis, currencies of those countries with flexible FX regimes depreciated (i.e. HU, PL, CZ), which had a dampening effect on EUR-denominated labour costs (6-15% decline). While posing a problem for some FX borrowers in Hungary and Poland, the depreciation was in general useful to boost price competiveness quickly. Labour cost growth both in Slovenia and Slovakia, which had introduced the EUR, only slowed down but did not reverse like in the other CE peers. Post-crisis, wage developments showed a much weaker performance, previous strong growth rates were not reached again. In relation to German wage costs, which picked up post crisis, the CE wage costs (in EUR-terms) broadly stagnated or even fell slightly.

As with wage developments, the dynamics of unit labour costs (ULC) mirror the catch-up process in CE. Since 2005, ULC (calculated in LCY) in CE countries increased between 10% and 20% (i.e. slightly more than the 10% seen in Germany). However, a strong upward bias in ULC indices is not a surprising feature for catch-up economies, and no indication for economic excesses on its own. If FX effects are included (i.e. ULC are converted to EUR), which makes ULC better comparable, the countries with strong FX appreciation in the past like Slovakia (ahead of EUR introduction) and Czech Republic tend to show even stronger cumulative gains in ULC over the last decade (over 30% appreciation since 2005). On the other hand, in case of Hungary, which currency depreciated significantly, ULC have been flat since EU accession.

At the same time, the distinction between pre- and post-crisis times is clearly visible in ULC dynamics as well. After the financial crisis, ULC tended to grow much slower or even tended to stagnate. Therefore, for some countries ULC dynamics of recent years have undershot the ones in Germany, indicating an improvement of the competitive position towards "core" euro area countries.

Financial analyst: Andreas Schwabe, CFA

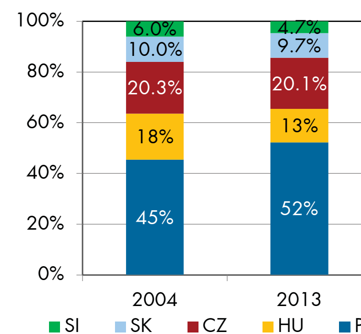
All trends sketched previously have important implications for the medium-term growth outlook. The high quality of economic integration in CE offers room for sound economic expansion going forward. However, annual GDP growth rates several times higher than in the most competitive Western European economies are likely to be a thing of the past. Given already high FDI stocks and substantial shares of intra-EU trade in total CE trade volumes, the CE countries cannot integrate once again into the EU economic structures. Moreover, it will be hard to achieve additional significant world market export share gains going forward. Therefore, export growth rates or FDI-driven investment growth rates seen of the last decade are unlikely to be repeated. Most recent GDP data out of CE have clearly shown that it is increasingly difficult to leverage GDP growth in Germany. Nevertheless, the high quality of economic integration in CE has several important implications beyond the CE region. Firstly, the CE countries could be important contributors to the European (EU) goal to increase the overall competitiveness of the European economy and the share of industry in GDP in particular. The positive contribution of the CE countries to the overall European competitiveness is well reflected in the so-called GCESC nexus (see p. 7). Secondly, the experience of the CE countries is a decent proof of the possibilities EU economic integration can offer to countries that are ready to exploit them.

Banking sector integration in CE

The CE countries attracted substantial FDI into their banking sectors since the end of the 1990ies. The strong FDI penetration in the CE banking sectors was driven by a mix of so-called push and pull factors. Like with FDI in general there were also substantial anticipation effects at work here (i.e. most market entries of foreign banks into the CE region took place well before formal EU membership was achieved). By and large foreign banks entered the CE markets due to the prevailing strong degree of financial under-penetration. The latter was a result of both, the non-existence of private sector banks in communist times and harsh restructuring in several CE banking sectors in the 1990ies. Hence high foreign-ownership ratios in CE are also a reflection of crisis clean-up, an aspect that also has relevance for Western Europe at present. For a longer period of time all CE countries were profitable high-growth markets for Western European banks. Pre-crisis (i.e. in the years 2000-2008) annual loan and asset growth rates in high double-digit territory were the "normal", flanked by high Return on Equity (RoE) readings.

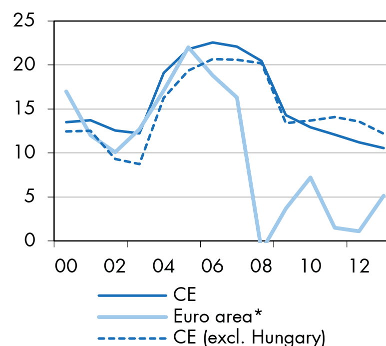
However, the long-term effects of this period of growth are a mixed bag. In Poland, the Czech Republic and Slovakia past financial sector growth was clearly not excessive. Here banking sector growth more or less followed a long-term financial intermediation trend that prevails in a less leveraged but bank-based economy (i.e. with low private sector leverage) like Germany. Moreover, by and large funding strategies and underwriting standards in those three markets remained at sound levels over the last cycle, which also speaks for a certain level of financial conservatism in Poland, the Czech Republic and Slovakia. This cannot be said for Hungary and Slovenia. In case of Slovenia the past financial sector expansion (or inter-temporal income smoothing) was clearly excessive. From a long-term perspective Slovenia more or less pursued a financial intermediation path that is more characteristic for overleveraged countries in the euro area periphery rather than a country like Germany. With regards to the banking sector trends in Slovenia it has to be added that past overexpansion was largely concentrated in the corporate segment (with linkages to real estate financing). In case of Hungary banking sector problems, that became evident in recent years, are more related to a deterioration of underwriting standards (including widespread FCY lending to private individuals in risky customer segments) and aggressive funding strategies (as shown by an overstretched loan-to-deposit ra-

CE: Regional GDP share trends*



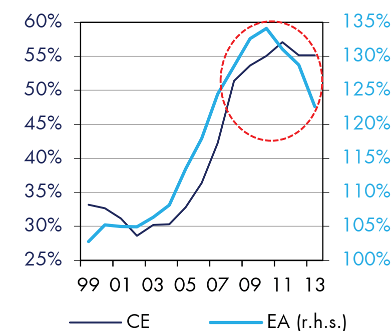
* % of regional CE GDP, based on nominal GDP figures in EUR-terms
Source: Eurostat, national sources, Raiffeisen RESEARCH

RoE: CE banking vs. EA (%)



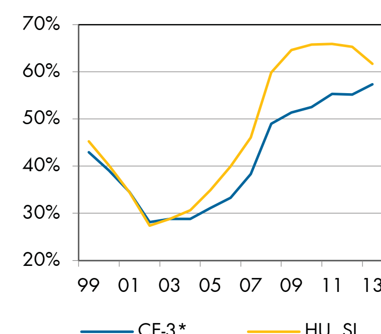
* Euro area data 2013 for H1
Source: ECB, national sources, Raiffeisen RESEARCH

CE vs. euro area: Total loans*



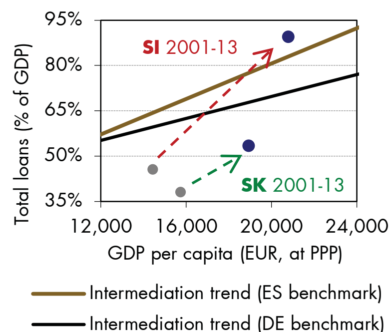
* % of GDP, excluding MFI business
Source: ECB, national sources, Raiffeisen RESEARCH

CE: Total loans (% of GDP)



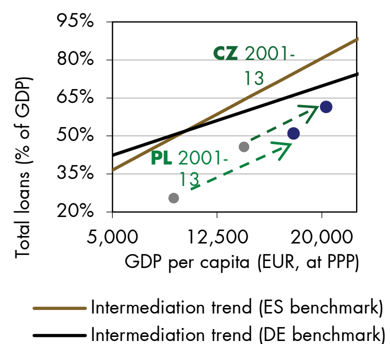
* CE-3: PL, CZ, SK
Source: ECB, national sources, Raiffeisen RESEARCH

CE: Financial intermediation trend*



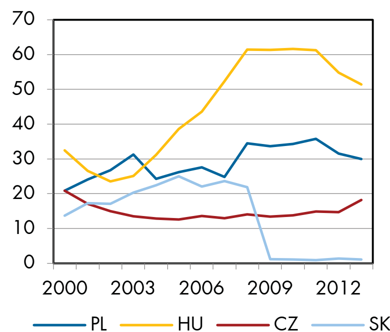
* Grey dot shows GDP per capita/loan-to-GDP relationship in 2001, blue dot in 2013
Source: ECB, national sources, Raiffeisen RESEARCH

CE: Financial intermediation trend*



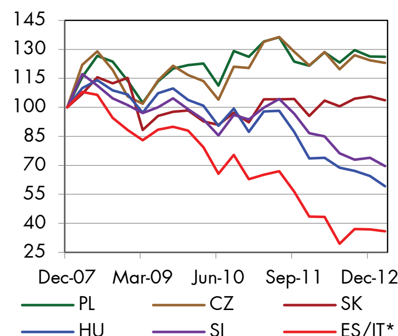
* Grey dot shows GDP per capita/loan-to-GDP relationship in 2001, blue dot in 2013
Source: ECB, national sources, Raiffeisen RESEARCH

CE: FCY loans (% of total loans)



Source: national sources, Raiffeisen RESEARCH

BIS cross-border claims**



* unweighted average Spain, Italy
** BIS-reporting Western European banks, 2007 = 100
Source: BIS, Raiffeisen RESEARCH

tio). FCY lending in Hungary increased well above the levels in other CE countries due to a high interest rate differential between rates in LCY and FCY (which partially reflects unsustainable economic policies) as well as lax regulation (e.g. compared to Poland). In this context it has to be also mentioned that brisk loan growth (or banking on "catching-up") in Hungary continued, although catching-up in the overall economy already stalled well before the 2007/08 crisis.

Banking sector catching-up in Poland, the Czech Republic and Slovakia over the last cycle was clearly sustainable and the absence of deleveraging needs now bodes well for the economic recovery. With regards to the Polish banking sector it has to be added that there were some signs of overheating in 2006 and 2007, but the Polish banking sector joined the CE "banking catch-up party" rather late. Therefore, one could even say that the 2007/08 crisis has hit the Polish banking sector exactly at the right time (i.e. before a possibly unsustainable expansion could have kicked in). Financial intermediation levels in CE on average are still at modest levels compared to income levels – with the exception of Slovenia. In fact, in most CE countries financial intermediation levels are still below levels that could be considered as sustainable from a long-term perspective. Therefore, there remains some catching-up potential in CE banking sectors driven by the sound position of the larger CE markets, which points to the outlook that another round of financial deepening (with banking sector growth well above GDP growth) looks feasible. The potential in the CE banking (excluding Hungary and Slovenia) is also well reflected in the increasing refocusing of larger Western European banks on these markets. On average, Western European banks have increased their exposure to CE markets considerably, compared to a lot of other CEE banking markets, since 2007/08. This trend development is definitely driven by the remaining growth potential as well as an overall sound through-the-cycle profitability in CE banking. That said and compared to the euro area there is nothing like a (cross-border) banking sector deleveraging in CE. However, this does not rule out that Hungary and Slovenia also experienced a substantial cross-border financing and asset-based deleveraging, by and large driven by domestic factors. From 2007 to 2013, the CE share of total CEE exposures of the Western European banks increased by some 4pp from 54-58% (which puts the relative increase at some 7% when starting levels are taken into account). Conversely, the relative share of SEE exposures in the overall CEE exposure at Western European banks dropped by 3pp over the same period and stood at about 20% as at year-end 2013. At first sight this decrease looks modest, but if starting levels are accounted for, it implies overall cuts of some 12%. The relative share of the CIS exposure at Western European banks has remained almost flat with a marginal change from 20.5% to 19.5% between 2007 and 2013. As already mentioned on a country level, there had been considerable divergences. In relative terms, in CE the exposures towards Poland and the Czech Republic increased substantially between 2007 and 2013 (i.e. by ~30%). Exposures to Slovakia increased less strongly with a modest, single-digit relative increase of 4%. By contrast, Hungary and Slovenia experienced drastic cuts of 30-35%.

Financial integration in terms of foreign-ownership ratios in the CE banking sectors stands well above (Western) European average levels. This has several important implications. Firstly, the CE banking sectors are highly dependent on banking market developments in Western Europe. Secondly, the current reshaping of the banking sector oversight and regulation inside the euro area also has significant spillovers to non-euro area CE countries. For more details see the Focus on section on p. 11.

Focus on: CE and "Banking Union"[1]

The foundation of the so-called "Banking Union" (BU) in the euro area involves the concentration of the Single Supervisory Mechanism (SSM) and banking supervision at the European Central Bank (ECB) along with the Single Resolution Mechanism (SRM), the phasing-in of a unified bank resolution and "bail-in" procedure, which will put the euro area well ahead of other jurisdictions. Moreover, the BU will strengthen the cross-border dimension of European banking supervision and regulation. The last few years revealed sizeable and complex cross-border banking linkages. Therefore, the foundation of the BU is also in the interest of the CEE countries, as the related tensions in major Western European banking sectors caused negative spillovers in CEE. Greater and more stable confidence in the viability of Western Europe's banking sectors, based on the BU architecture, may now produce positive effects in CEE (e.g. as mirrored by the broad-based decline of bank funding costs in recent years, which also benefits larger Western European banks in CEE). For euro area members in CE (e.g. Slovakia, Slovenia) there is no choice. They have to follow the rules of the game inside the BU. However, for CE countries such as Poland, the Czech Republic or Hungary (still outside the euro area) the question as to whether they should join the BU on a voluntary basis (as offered by current regulations) remains.

Beyond the political sphere, there are some valid arguments for the claim that having as many non-euro area EU countries as possible on board would make sense. Foreign ownership ratios in the CE banking sectors are well above the levels in most euro area countries and European financial and banking sector integration extends well beyond the euro area. Consequently, very broad-based SSM participation might also help to prevent contrasting regulations at national levels (e.g. where national interests are in conflict with the overlapping European goals of the single market). Furthermore, although complex by nature, decision-making inside the SSM/SRM might still be faster than less organized home/host regulatory coordination outside the SSM. And in any event, decisions taken within the SSM and SRM may have significant spillover effects on non-opt-in countries. Therefore, BU participation by the non-euro area CE countries can ensure that their interests are reflected in broader European regulation. In addition, there are definitely some aspects where the CE banking sectors deviate from those in Western Europe (e.g. measurements of the credit-to-GDP gap within the Basel III framework, which are relevant to countercyclical capital buffer implementation (CCB) and may have to be treated more cautiously in CE than in Western Europe). From a private sector perspective, the broad-based participation of non-euro area CE countries could also be highly beneficial. Firstly, SSM participation might assist the streamlining of the supervision of large cross-border banks (i.e. for large cross-border banks the costly multiplication effects of dealing with and reporting to several regulators with different legislations would be reduced considerably). This may also help to lower overall compliance and supervisory costs significantly. The latter might also be in the interests of several CE countries given the relatively small size of their banking sectors (and hence their revenue bases). Moreover, broad-based SSM participation could assist the limitation of national ring-fencing and/or additional uncoordinated local regulation that sometimes lead to even higher market risks at the group level of large cross-border banks in CEE. Furthermore, opt-in countries within the BU would still have the possibility to apply a wide range of national (macro-prudential) regulation despite the centralization of micro- and macro-prudential supervision at the ECB. However, there are also several arguments, which could keep non-euro area countries in CE from joining the BU at least for the time being. For instance SSM participation is also linked to SRM participation and this makes the choice far from easy. The SRM implies mutual burden sharing (via its Single Resolution Fund, SRF), which looks less attractive from a CE perspective. This holds especially true, as the SRF could ultimately result in some pooling or mutualization of national resolution funds. The fact cannot be ignored that with the exception of Slovenia, banking crisis costs are concentrated in the Western European banking sectors and there remains some uncertainty with regard to their legacy assets. Moreover, in CE countries traditional lending dominates the banks' balance sheets (which is not the case in all the larger euro area banking sectors). Moreover, the CE countries tend to have much lower L/D ratios, while all CE banking sectors are characterized by far lower overall leverage ratios than the largest euro area banking sectors. Therefore, several CE countries could be de facto liquidity providers within the SSM and it remains unclear as to how this rule would be handled in times of crisis.

However, it has to be stressed that in the case of disagreements, non-euro area countries would have the option of leaving the SSM (and hence the SRM) with the possibility of re-entry after a certain period of time. On the one hand, such a flexible opt-in and opt-out mechanism (a fairly new aspect of European politics) could make sense, but on the other, it is obvious that in a more volatile market environment an opt-out, following a previous opt-in, may at least temporarily add to uncertainty. Decision-making structures in the SSM are given, providing CE countries with some important constraints (e.g. that non-euro area countries cannot be part of the ECB Governing Council). However, the problem remains that the CE sectors are very small in comparison to the euro area aggregate (total loans in all five CE countries currently total just 2.97% of the euro area's total loan stock). Therefore, the concerns of the CE banking sectors, which could also arise in the case of voluntary BU participation, may not receive sufficient attention inside the BU, in spite of the fact that voluntary participation would mean that a large part of the banking assets in non-euro area CE countries would be part of the SSM. Furthermore, in several CE countries there is also some skepticism with regard to the complexity of the BU and the current Western European focus on macro-prudential regulation. In CE sound business models and soundness at the micro-level are seen as being key to financial sector stability. Therefore, we think that a likely scenario will involve non-euro area countries in CE taking a wait and see stance with regard to the option of joining the BU on a voluntary basis. The position recently adopted by the local authorities in the Czech Republic, Poland and Hungary is fairly skeptical with regard to the handling of their interests within the BU framework that is currently evolving. Therefore, it will be crucial that pan-European institutions for banking regulation such as the European Banking Authority (EBA) and the European Systemic Risk Board (ESRB) keep a close watch on the consistency of regulation inside the BU (substantially driven by the ECB) and within the EU as a whole. Moreover, it will be up to the non-participating CE countries to remain as close as possible to the BU in terms of regulatory standards in order to avoid competitive disadvantages and/or regulatory arbitrage.

As far as near-term business prospects are concerned, say for the next 1-3 years, the decision as to whether a non-euro area CE country will or will not opt-in for the BU is unlikely to have a strong influence. A non-opt-in would not represent a change to the status quo and banks operating in the region are used to the sometimes complex home/host supervisory coordination in CEE. In addition, overall business strategies will be determined to a far greater extent by market-related factors. However, from a long-term perspective an uneven playing field in terms of regulation and supervision may still have a slightly negative impact (definitely also depending upon the concrete national regulation of an opt-out country). Nevertheless, it has to be stressed that, going forward, there should not be any de-facto or de-jure differentiation from home country supervision inside the BU with regard to participating, opt-in and non-opt-in CE countries.

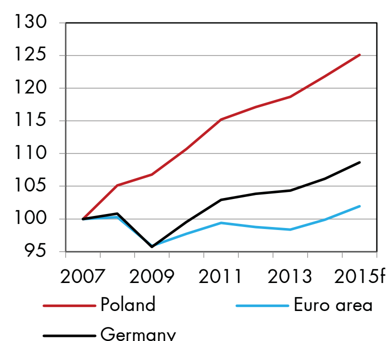
Financial analyst: Gunter Deuber

1 *taken out of the forthcoming Raiffeisen RESEARCH CEE Banking Sector Report 2014*

Poland: Significant EU benefits on the table for 2014-2020

- **One of the most resilient EU economies trough-the-cycle, real convergence accelerated recently**
- **Strong trade relations within the EU prevented a fall into recession in recent years**
- **Somewhat more critical attitudes towards EU, but large benefits on the table from EU budget**

Real GDP Index (2007 = 100)



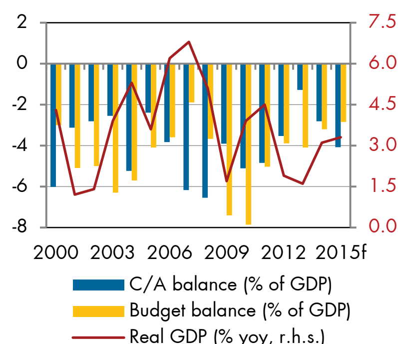
Source: Eurostat, national sources, Raiffeisen RESEARCH

Key economic indicators

	2000	2004	2013
Real GDP (EUR bn)	186	205	389
% of CE	52%	45%	52%
% of EU	2.0%	1.9%	3.0%
GDP p.c. (PPP, EUR)	9,200	11,000	18,000
% of CE	87%	84%	98%
% of EU	47%	50%	66%
CPI (% yoy, avg)	10.1	3.5	0.9
Unemployment (%)	15.5	19.5	13.6
Trade (% of GDP)	60	77	91
Share EU world market exports (%)	1.5%	2.0%	3.5%
FDI (% of GDP)	25	34	47
FDI (% of EU)	1.5%	1.8%	3.0%
C/A (% of GDP)	-6.0	-5.2	-1.3
Public debt (% of GDP)	37	46	57
Loans (% of GDP)	25	24	51
LCY/EUR (avg)	4.0	4.5	4.2

Source: Bloomberg, national sources, Eurostat, UNCTAD, Raiffeisen RESEARCH

PL: Long-term economic trends



Source: Eurostat, national sources, Raiffeisen RESEARCH

Undoubtedly during the last ten years the Polish economy was influenced favorably by EU funds and free trade. From May 2004 to April 2013 net transfer of EU funds amounted to some EUR 62 bn. This sum clearly helped in modernizing infrastructure, industry and agriculture, all which contributed significantly to GDP growth. The lifting of trade barriers, in turn, boosted trade volumes and attracted FDI. In 2013 annual export and import volumes were respectively 190% and 160% higher than in 2003. Moreover, over the last two years, when most EU countries were stuck into recession, net export was the main driver of GDP growth and its contribution prevented Poland to fall into recession. Solid pre-crisis economic expansion also accelerated the process of economic catching-up with the EU average. More controversial is the impact of EU membership on the local labor market. It is estimated that between 2004 and 2012 some 1.2 mn Poles left for (Western European) EU countries. That significantly favored a drop in unemployment which in the short term may be perceived positively. When Poland entered EU the unemployment rate exceeded 19%, now it stands at some 13%. However, such a brain drain is an unquestionable loss and may cause adverse long-term effects, in particular when the society is getting older and qualified workforce becomes scarce.

Accession to EU also increased the influence of Poland in international relations somewhat. Its image among the economic and political communities in European and non-European countries improved substantially. Moreover, Poland participated also more and more actively in setting the EU policy agenda. In 2011 Poland took the first presidency of the EU in history. But EU membership involved also an obligation to introduce visas for citizens of third (non-EU) countries which resulted in a decline in visitors in hotels and sales at commercial and catering facilities in border areas (e.g. to Ukraine, Belarus). Moreover, Poland was obliged to introduce many various regulations which impacted adversely on Polish entrepreneurs. Also Polish social life was influenced significantly by the EU accession. Open borders made the Polish society much more mobile and triggered substantial migration moves. The main destinations were UK, Ireland, Germany and France. Although the living standard of households increased during the last 10 years, a convergence of many prices to EU averages disadvantages the overall Polish society as wages are still much below the average EU level.
All in all, Poland's EU-membership brought more benefits than costs, in particular to the economy. This positive balance should even widen in the coming years as Poland is one of the countries that may benefit the most from the new 2014-2020 EU budget, which may support additional catch-up. However, recent EU and euro area crisis events negatively influenced the attitudes vis-à-vis the EU in Poland. In April 2014 support for Poland's EU membership decreased to 73% and is at a similar level as in the first period after the accession (against pre-crisis levels of close to 90%). However, it should be noted that in comparison with attitudes towards EU in a lot of other EU countries, Poles are still above the EU average.

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Hungary: Staying in a difficult marriage

- **Convergence expectations – also fuelled by domestic and EU politics – did not materialize**
- **Lack of economic performance – real GDP still below 2007/08 level – supports anti-EU rhetoric**
- **Hungarian population has still kept a relatively pro-EU stance, both for practical and sentimental reasons**

In the pre-accession period there were big hopes associated with EU membership in Hungary. Most importantly there was a widespread idea that EU membership will foster (real or income) convergence. There was a very strong popular support, a national consensus with regards to Hungary's political and economic orientation towards EU. Hence, 84% of voters voted in favor of EU membership in April 2003.

Unfortunately the past ten years did not bring the expected real convergence. Eurostat data (i.e. GDP per capita at PPP in % of the EU) do show more or less no convergence over the last 7-10 years. And more granular data show an even less benign picture: household consumption in 2013 is below the 2004 level. A relatively strong convergence in the 1998-2006 years was increasingly based on strongly increasing indebtedness in private and public sector. A certain fiscal adjustment started already in 2006, but the (global) 2008 crisis hit an extremely vulnerable country. Since then the Hungarian economy has not been able to post meaningful GDP growth, modest growth started in H2 2013 only.

The initial positive expectations towards EU membership were also partially disappointed by the delay of free movement of people (i.e. Schengen treaty was extended to Hungary only in 2007, most rich EU member-states restricted free movement of labor). In the same time, a significant part of the undercapitalized Hungarian SME sector (i.e. food processing) was strangled by intense competition within the single EU market almost immediately. Hence the initial optimism towards EU membership in Hungary quickly eroded. Back in 2002 (2 years ahead of EU accession) 76% of the population believed that EU membership is going to be beneficial for the country and only 9% expected the opposite. The two camps equaled already by 2005 (41% positive vs. 42% negative). Nowadays Hungarians still moderately support EU membership in general, but there is growing discontent in politics vis-à-vis the EU and its institutions. It is quite telling that radical right Jobbik party with harsh anti-EU rhetoric became quite successful and got 17% of the votes (in general national elections) in 2010 and 21% in 2014. Also, there are mass rallies organized by government friendly civil groups in favor of the country's sovereignty vs. the interference of the EU. The official attitude towards euro area membership has also turned around. The centre-right government under PM Orbán aimed to adopt the EUR as early as possible in 2002 (with the ambitious target date of 2007), but the target date was gradually postponed under the centre-left governments later on, and the crisis washed away any official target dates later on. Nowadays, PM Orbán is inclined not to enter the euro area in the foreseeable future.

While politics might be toying with anti-EU rhetoric from time to time, there is a dire need for EU funds in order to modernize the Hungarian economy. In the first 10 years of EU membership, Hungary's net financial position with the EU shows a surplus of EUR 23 bn (equaling an annually inflow of 2.5% of GDP). The population's support of EU and its institutions is still higher than inside the EU-28 or in regional CE peers (only 34% of Hungarians think the country would better face a future outside EU and - maybe surprisingly - 55% do support the euro area entry).

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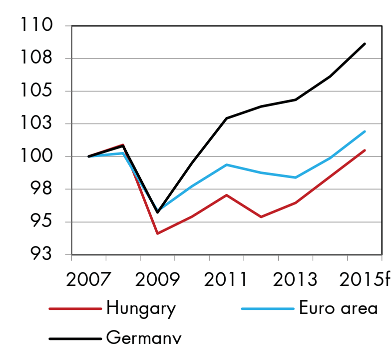
Real GDP Index (2007 = 100)



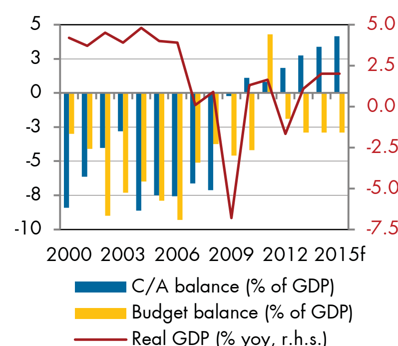
Source: Eurostat, national sources, Raiffeisen RESEARCH

Key economic indicators

	2000	2004	2013
Real GDP (EUR bn)	52.0	82.1	97.9
% of CE	15%	18%	13%
% of EU	0.5%	0.8%	0.8%
GDP p.c. (PPP, EUR)	10,680	13,658	15,480
% of CE	101%	105%	84%
% of EU	55%	62%	62%
CPI (% yoy, avg)	9.8	6.8	1.7
Unemployment (%)	6.4	6.2	10.4
Trade (% of GDP)	152	130	180
Share EU world market exports (%)	1.2%	1.4%	1.8%
FDI (% of GDP)	54	60	82
FDI (% of EU)	1.0%	1.3%	1.3%
C/A (% of GDP)	-8.4	-8.6	2.8
Public debt (% of GDP)	56	60	79
Loans (% of GDP)	29	40	48
LCY/EUR (avg)	260	252	297

Source: Bloomberg, national sources, Eurostat, UNCTAD, Raiffeisen RESEARCH

HU: Long-term economic trends

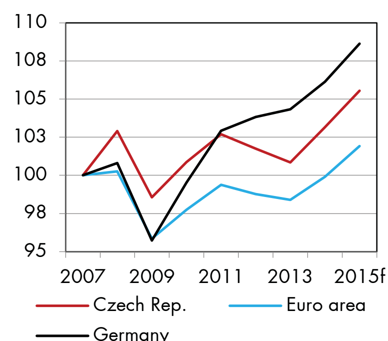


Source: Eurostat, national sources, Raiffeisen RESEARCH

Czech Republic: Sound fundamentals, but structural challenges

- **Most of the key structural features like export orientation developed ahead of EU entry**
- **Slowdown in convergence also due to fiscal austerity and insufficient drawing of EU funds**
- **Commitment to adopt euro in mid-term as factor to push forward with structural reforms**

Real GDP Index (2007 = 100)



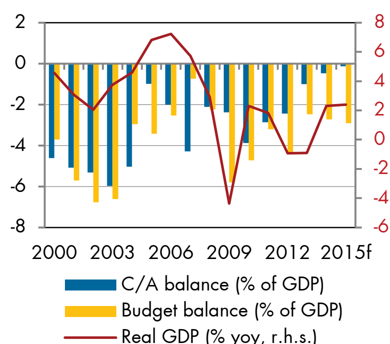
Source: Eurostat, national sources, Raiffeisen RESEARCH

Key economic indicators

	2000	2004	2013
Real GDP (EUR bn)	63.8	91.8	150
% of CE	18%	20%	20%
% of EU	0.7%	0.9%	1.1%
GDP p.c. (PPP, EUR)	13,514	16,914	20,337
% of CE	127%	129%	111%
% of EU	71%	77%	85%
CPI (% yoy, avg)	3.9	2.8	1.4
Unemployment (%)	8.0	9.2	7.6
Trade (% of GDP)	124	125	150
Share EU world market exports (%)	1.1%	1.6%	2.3%
FDI (% of GDP)	48	50	70
FDI (% of EU)	0.9%	1.2%	1.7%
C/A (% of GDP)	-4.6	-5.0	-1.0
Public debt (% of GDP)	19	30	46
Loans (% of GDP)	50	39	65
LCY/EUR (avg)	35.6	31.9	26.0

Source: Bloomberg, national sources, Eurostat, UNCTAD, Raiffeisen RESEARCH

CZ: Long-term economic trends



Source: Eurostat, national sources, Raiffeisen RESEARCH

The EU entry in 2004 did not have any significant effect on the structure of Czech trade balance as the structural change occurred much earlier than in 2004. The share of exports into EU rose from roughly 50% in 1990 to 80% in 1994. In these years the Czech economy had to reorient exports from eastern markets to developed western markets. This reorientation of the economy was very costly in terms of output and employment. The emerged structure persists into these days, even though the euro Area debt crisis has forced some exports to new markets outside the EU. Since 2005, the Czech Republic reports surpluses in foreign trade. Strong FDI inflows into the Czech Republic have mirrored the attractiveness of the country for foreign investors, among other, because of a well-educated workforce. Due to the openness of the Czech economy, EU and global demand remain the key variable when it comes to economic forecasts. Nevertheless, with GDP per capita at above 80% of the EU average (at PPP), the domestic policy should avoid mistakes that would hinder the continuation of the catch-up process. The exemplary sample of such failure was insufficient drawing of EU funds in the period of 2007-2013, EU funds might add to annual real economic growth by more than 2 pp each year; More recently, worsening results in education ranks such as PISA, however, are posing a headache for Czech policymakers. Another long-term challenge is the slow decline in the productive population. There is a need to advance with long-term issues such as pensions, health care, education and public administration and control. Moreover, there is no guarantee that the Czech policy makers are able to deliver.

The Czech Republic's catch up process was very successful after but also before the EU accession. However, even prior to the global financial crises this process stopped. The drop of foreign demand hit the small and very open Czech economy significantly. But this is not the full story. Importantly, the Czech government adopted an overly restrictive fiscal policy during the euro area crisis, not counterbalanced by a more expansionary monetary policy; the latter changed only in 2013. The fiscal policy response was not commanded by the bond markets as was the case in several peripheral European countries. Already in 2003 – 2004, the Czech 10-year government bond yield was even slightly lower than the German counterpart. This was possible, as nominal convergence happened mostly via domestic currency appreciation while the inflation rate was successfully kept at low levels. When the European crises calmed down the yield spread over the German 10-year Bund again almost vanished. The financial market is aware of the solid Czech fundamentals such as low domestic as well as foreign indebtedness which translates into cheap financing for the Czech government, enterprises and also households. The commitment to adopt the euro in the future provides an important element to push forward with sound economic policies. A new centre-left government is ready to open the discussion about the timing of euro. However, in our view, an euro area entry is not yet on the agenda for next four years.

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Slovakia: Clearly a success story of EU enlargement

- **EU membership in combination with structural reforms boosted economic convergence**
- **Free movement of labor force helped to decrease the unemployment rate significantly**
- **EU funds provide visible impetus for economy**

Back in 2000, Slovakia was considered as laggard among the neighboring CE countries. Slovakia missed the first wave of NATO enlargement (1999) and there were serious doubts about being in the first big wave of EU eastward enlargement in 2004. Fortunately, a new pro-European and pro-reform government managed to catch the train and Slovakia joined EU on May 1st 2004. Moreover, just one month before EU enlargement, Slovakia joined NATO. The implemented deep structural reforms started a fast economic convergence, which was reinforced by the euro introduction on a sustainable basis in 2009. Therefore, we consider Slovakia's case as a big success story of EU membership.

During the last 10 years, there were several important events (structural reforms, great recession, euro area entry in 2009) that make it nearly impossible to isolate the potential positive/negative effects of EU membership on the economy. From a Slovak perspective, the biggest benefit of being an EU member is the openness to trade with Western countries. Slovakia is among the most open EU economies, which implies a high degree of competitive pressure. But the positive impact on the economy and the improvement in household wellbeing is clearly visible. Vivid trade with Germany and other euro area countries also supported the decision to introduce the euro as one of the first countries in CE. The other, similarly important, benefits of EU membership are a stable legal environment, which helps to attract FDIs. Citizens especially welcomed the possibility to travel without passport control and the free movement of labor. Around 140.000 Slovaks are currently working abroad and without this possibility, the Slovak unemployment rate would be 4 pp higher than now (currently at some 14%). The inflow of EU funds also helps to restore the infrastructure and supports companies in their investments into new productive technologies. On the other hand, the EU funds are often mentioned to be a source of corruption, which points to some prevailing institutional shortcomings.

The developments in Slovakia clearly illustrate that EU membership alone is not enough to ensure economic convergence. But in combination with internally driven structural reforms EU membership can bring lot of benefits. Slovakia now enjoys a healthy economy generating a big trade surplus, a stable banking system and solid public finances. In terms of financial market pricing and financial market access this combination puts Slovakia close to so called "core" countries of the euro area like Austria, the Netherlands; the remaining premia in Slovak bonds largely reflects a liquidity pick-up. The current GDP level per capita reaches almost 80% of EU level. However, the experience of some countries in the euro area periphery or Slovenia shows that in order to sustainably breach this level there is a need for further – and more sophisticated - reforms of e.g. judiciary, schooling and functioning of government agencies (e.g. tax offices). As things stands Slovakia is committed to do these reforms.

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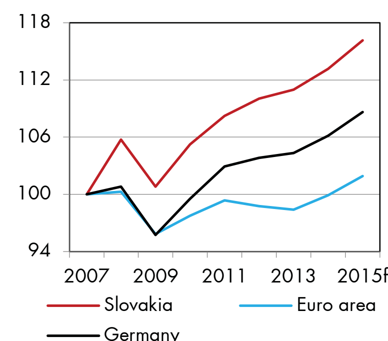
Real GDP Index (2007 = 100)



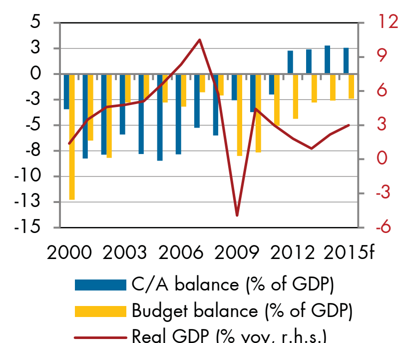
Source: Eurostat, national sources, Raiffeisen RESEARCH

Key economic indicators

	2000	2004	2013
Real GDP (EUR bn)	31.2	45.2	72.1
% of CE	8.8%	10.0%	9.7%
% of EU	0.24%	0.32%	0.55%
GDP p.c. (PPP, EUR)	9,500	12,300	18,943
% of CE	90%	94%	103%
% of EU	52%	58%	77%
CPI (% yoy, avg)	12	7.5	1.4
Unemployment (%)	18.6	18.1	14.2
Trade (% of GDP)	143	151	175
Share EU world market exports (%)	0.5%	0.7%	1.5%
FDI (% of GDP)	36	51	61
FDI (% of EU)	0.30%	0.58%	0.72%
C/A (% of GDP)	-3.5	-7.8	2.4
Public debt (% of GDP)	50	41	55
Loans (% of GDP)	42	23	55

Source: Bloomberg, national sources, Eurostat, UNCTAD, Raiffeisen RESEARCH

SK: Long-term economic trends



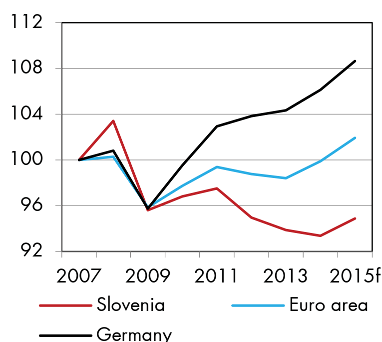
Source: Eurostat, national sources, Raiffeisen RESEARCH

Raiffeisen RESEARCH

Slovenia: Paying the price for overly ambitious convergence

- **Excessive and externally financed bank leveraging, supported by early euro area entry, resulted in boom-bust pattern**
- **Poor post financial crisis economic performance on slow reforms, real GDP still well below 2007/08 level**
- **Strong export sector and most recent adjustments as fundament for the recovery**

Real GDP Index (2007 = 100)



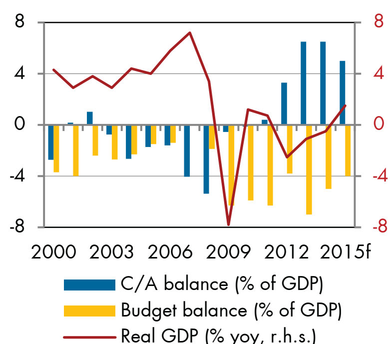
Source: Eurostat, national sources, Raiffeisen RESEARCH

Key economic indicators

	2000	2004	2013
Real GDP (EUR bn)	21.3	27.2	35.2
% of CE	6.0%	6.0%	4.7%
% of EU	0.24%	0.26%	0.27%
GDP p.c. (PPP, EUR)	15,180	18,700	20,800
% of CE	143%	143%	113%
% of EU	80%	86%	86%
CPI (% yoy, avg)	8.9	3.6	1.8
Unemployment (%)	7	6.3	10.5
Trade (% of GDP)	110	116	141
Share EU world market exports (%)	0.3%	0.4%	0.5%
FDI (% of GDP)	16	22	34
FDI (% of EU)	0.12%	0.16%	0.20%
C/A (% of GDP)	-2.7	-2.6	6.5
Public debt (% of GDP)	26	27	65
Loans (% of GDP)	36	47	74

Source: Bloomberg, national sources, Eurostat, UNCTAD, ECB, Raiffeisen RESEARCH

SI: Long-term economic trends



Source: Eurostat, national sources, Raiffeisen RESEARCH

Up until the global financial crisis in 2008/09 Slovenia was considered a "regional star" in CE. This perception was based on the very quick entry into the euro area in 2007 as well as above regional income levels and dynamics. Starting from a high level above 70% of the euro area GDP per head in 2000, the income level reached 90% ahead of the financial crisis in 2008.

However, with the benefit of hindsight it is obvious that large parts of the past economic and income convergence in Slovenia had been hardly sustainable. Before that, between 2004 and 2007/2008, Slovenia experienced a strong, mostly externally financed expansion of (private sector) credit, driving up the loan-to-GDP ratio significantly. In recent years Slovenian banks had to pay the price for this brisk speed of expansion (indicated by a double-digit NPL ratio and several consecutive years of negative banking sector profitability). Brisk lending activity also fostered economic overheating in Slovenia with a large positive output gap in the later stage of the credit boom. Since the year 2008 Slovenia has suffered the most from all CE economies – the GDP contraction in 2009 was the biggest among CE countries (-7.8% yoy) – and real GDP has not reached its pre-crisis level up to now. This very negative performance is also a reflection of less ambitious restructuring and reforming following the global financial crisis. Given the lacklustre economic performance and the fallout from the banking sector bust on the public sector balance sheet, for some time Slovenia was a candidate for an IMF/EU bailout (at least for a banking sector package like in Spain). A turn to IMF/EU may have also resulted in a more decisive reforming (as the IMF/EU is usually a good external scapegoat). All in all, Slovenia suffered from similar problems like some EU countries in the euro area periphery that were largely a result of overoptimistic long-term expectations.

Despite all the negative trends, it should not be neglected that the Slovenian economy is still more an "Ireland" case than a "Portugal or Greece", backed by a fairly competitive export sector. Exports in real terms recovered over the last five years to the pre-crisis level. Moreover, a certain rebalancing in terms of Unit Labour Costs has started, based on nominal wage cuts. This is of special importance as nominal exchange rate flexibility vis-à-vis the most important trading partners in Western Europe is limited due to the euro area membership. Therefore, one has to say that now Slovenia pays a certain price for its ambitious euro area entry strategy (other CE countries like Poland, Czech Republic or Hungary profited from their exchange rate flexibility in recent years). Nevertheless, one has to add that EU and euro area membership also helped Slovenia to master its challenges. Without euro area membership and access to ECB liquidity banking sector problems could have been even worse and Mario Draghi's "ECB will do whatever it takes" speech also gave substantial support to Slovenia.

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