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FOR INTERNATIONAL POLICY

*International Economy Comments*

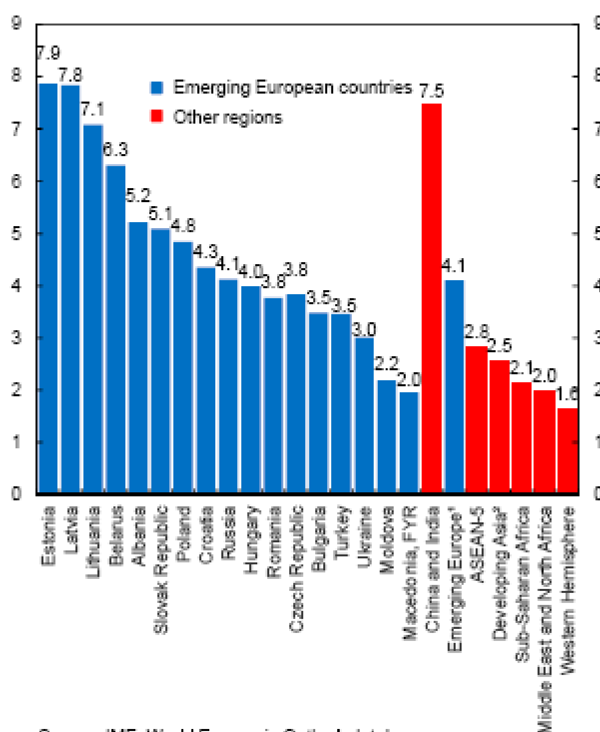
IEC #17 , 16 MAY 2011

# Rethinking emerging Europe's convergence model

*The global financial crisis has threatened Central and Eastern Europe's convergence progress, prompting a rethink of the region's development model.*

The global economic landscape is being reshaped by the Great Convergence – the onset of rapid economic growth in the big, populous economies of Asia.[1] But it's not the only convergence story in the world economy. Another successful example of convergence can be found outside Asia, in the economies of Central and Eastern Europe. In the period 1995-2007, GDP per capita in these emerging European economies grew at an annual rate of about four per cent – a result bettered only by the Great Convergence growth rates of China and India:

**Figure 38. Emerging Europe and Selected Regions: Real Per Capita GDP Growth, 1995–2007**
*(Annual percentage change in PPP terms)*




Source: IMF, World Economic Outlook database.
¹Includes Czech Republic and Slovak Republic.
²Excludes China and India.

Source: International Monetary Fund, *Regional Economic Outlook: Europe. Building Confidence*. (2010)

Like many other emerging markets, the region's growth performance was particularly strong over 2003-2007. But while this improvement may have been a relatively widespread one, the emerging European economies also managed to grow



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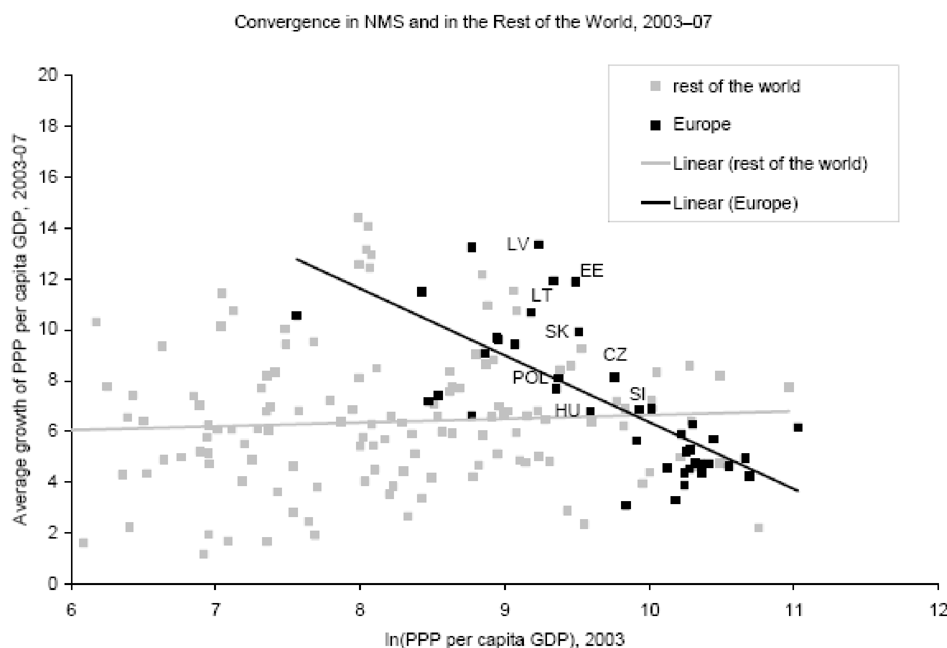
appreciably faster than economies in other regions with similar income levels. Those economies which acceded to the EU (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia all joined in 2004; Bulgaria and Romania in 2007) did particularly well. For these so-called new members states (NMS, also sometimes known as the EU-10), over the 2003-2007 period there was a significant negative relationship between countries' GDP per capita and their growth rates, indicating strong convergence. Convergence also took place *within* the NMS group, as economies with a lower starting GDP per capita tended to grow faster than their wealthier counterparts: [2]




The economic success of the NMS prompted interest in the region's growth model, involving as it did a kind of *űber*-globalisation whereby the NMS economies embraced big increases in both trade and financial integration. With the exception of Estonia, already a highly open economy by 1995, the trade-to-GDP ratio in the EU-10 increased by more than 20 percentage points between 1995 and 2007. At the same time, financial integration progressed even more rapidly: in many of the region's economies, the ratio of the sum of external assets and external liabilities to GDP rose from less than 100 per cent in the mid-1990s to above 200 per cent. [3] Of course, the real core of the region's development model comprised deep integration with the EU, a process that went well beyond trade and financial integration to encompass political integration, institutional development and labour mobility.[4]

Still, the large role played by financial integration was particularly striking, contrasting as it did with the much more cautious approach to capital inflows followed by a chastened East Asia in the aftermath of the 1997-98 crisis: while Asian policymakers tended to run sizeable current account surpluses, work hard to keep their exchange



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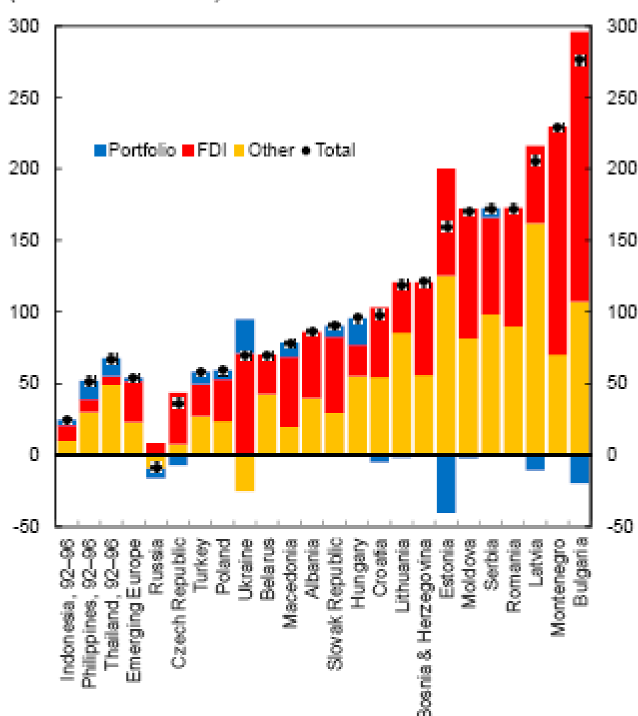
rates competitive and accumulate large stocks of foreign exchange reserves as a form of self-insurance, many of their EU-10 counterparts ran large current account deficits and accepted pronounced nominal and real exchange rate appreciations. This stark difference in approaches prompted observers to note that the EU-10 made for a potent exception to the stories being told elsewhere in the world economy of capital flowing 'uphill' from poor to rich countries and of capital imports generally bringing rather disappointing growth results for emerging economy borrowers.[5] For the NMS, not only was capital flowing downhill from the richer European economies to the poorer ones, but it also appeared to be bringing with it a substantial growth dividend.[6]

**Figure 43. Emerging Europe: Cumulative Net Capital Inflows, 2003–08[1]**
*(Percent of 2003 GDP)*




Source: IMF, World Economic Outlook database.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07 in percent of 2002 GDP.

Source: International Monetary Fund, *Regional Economic Outlook: Europe. Building Confidence*. (2010)

Over 2003-2008, the economies of the Balkans and Southeastern Europe in particular received extremely large net capital inflows. These contributed to a surge in credit growth and asset prices which in turn powered rapid growth in domestic demand and current account deficits, leaving the receiving economies increasingly exposed to the risk of an Asian crisis-style 'sudden stop' in capital inflows.



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All of this made the onset of the global financial crisis (GFC) – with its twin shocks to trade and capital flows – a powerful stress test for the region's development model. It was a test that in many ways it failed. The GFC hit the EU-10 economies much harder than it did other emerging economies at a comparable level of development: GDP growth collapsed across the region (with the exception of Poland) and in the case of the Baltic states, countries lost up to one-fifth of their output as those economies which had been most caught up in the capital-flow powered credit boom suffered the biggest downturns. Indeed, for the Baltics, convergence, even with a crisis-hit Western Europe, was transformed to a brutal divergence. And the recovery, when it finally arrived in late 2010, also turned out to be weaker than the one enjoyed by most other comparable emerging markets.[7]

It's not all gloom. Despite the severe damage caused by the GFC, the region did manage to avoid a complete currency and financial sector meltdown (thanks in part to non-Asian crisis-style support from the IMF and EU). The institutional development achieved during the rapid convergence period also proved to be more resilient than was feared at the peak of the crisis. And some countries came through relatively unscathed or even, in the case of Poland, saw an increase in the pace of convergence with Western Europe. Overall, however, policymakers in the NMS are now having to rethink the region's development model as they consider how best to get the convergence process back on track in the post-GFC world.

*Mark Thirlwell*
*Director, International Economy Program*
*Lowy Institute for International Policy*

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[1] On the Great Convergence, see IEC#4.

[2] Martin Cihak and Wim Fonteyne, *Five years after: European Union membership and macro-financial stability in the new member states.* IMF Working Paper WP/09/68. Washington DC, International Monetary Fund, March, 2009. Note that the chart is based on unweighted country observations. When these observations are weighted by country size (eg by population), convergence is also observed in the global sample.

[3] Stefania Fabrizio, Daniel Leigh and Ashoka Mody, *The second transition: Eastern Europe in perspective.* European Economy: Economic Papers 366. Brussels, European Commission, 2009.

[4] Torbjorn Becker, Daniel Daianu, Zsolt Darvas, Vladimir Gligorov, Michael Landesmann, Pavle Petrovic, Jean Pisani-Ferry, Dariusz Rosati, Andre Sapir and Beatrice Weder Di Mauro, *Whither growth in Central and Eastern Europe? Policy lessons for an integrated Europe.* Bruegel Blueprint 11. Brussels, Bruegel, November, 2010.

[5] See for example Eswar S Prasad, Raghuram G Rajan and Arvind Subramanian, Foreign capital and economic growth. *Brookings Papers on Economic Activity* 38 (1) 2007

[6] Abdul Abiad, Daniel Leigh and Ashoka Mody, Financial integration, capital mobility, and income convergence. *Economic Policy* 24 (58) 2009.

[7] Marcin Piatkowski, *Post-crisis prospects and a new growth model for the EU-10.* Central Europe Digest Report No. 33. Washington DC, Center for European Policy Analysis, 6 April, 2011.



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