Recent Developments and Future Prospects

Growth

The global recovery advanced in 2010, helped by robust growth in developed economies and buoyant growth in developing economies. Improving private consumption and stimulus measures supported the upswing in the US and Japan. Regional trade accelerated growth in China, India, Brazil and Mexico. World industrial production and world trade expanded by 9.1 percent and 21.7 percent, respectively, recouping their losses from 2009. The rebound in external demand supported the recovery in Europe. Growth in the EU reached 1.8 percent in 2010 after the decline of 4.2 percent in 2009 (Table 1).

Economic activity in the EU10 and EU15 rebounded in parallel. The business cycles aligned through the global upswing and close trade and production linkages within Europe made for a synchronized upswing across the EU10 and EU15. Growth improved by about 6 percentage points from 2009 to 2010 and reached 2.1 percent in the EU10 and 1.7 percent in the EU15 (Figure 1). While the annual growth numbers are similar, the growth dynamics differed between the EU10 and EU15. Year-on-year growth in the EU15 peaked in the second quarter of 2010 at 2.8 percent. Volatile financial markets, the end of the restocking cycle and an unwinding of fiscal stimulus dampened growth to 2.0 percent in the fourth quarter of 2010, even though net exports continued to support the expansion (Figure 2). In contrast, in spite of sluggish investment and weakening net exports, year-on-year growth in the EU10 improved continuously from 0.6 percent in the first quarter to 2.8 percent in the fourth quarter. This reflected persistent restocking on the back of increased capacity utilization and a rebound in consumption as households became more confident about the economic outlook (Figure 3).

Table 1. Global growth, percent

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<th>2009</th>
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<td>World</td>
<td>-0.6</td>
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<td>EU10</td>
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<td>EU27</td>
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<td>EU15</td>
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<td>Japan</td>
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<td>United States</td>
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<td>Emerging economies</td>
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<td>China</td>
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<td>India</td>
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<td>Mexico</td>
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<td>Russia</td>
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The accelerating growth in the EU10 during 2010 came with a broadening of growth across sectors. EU10 countries saw double-digits growth of industry, reflecting the rebound in global demand for capital goods and durables and the deep integration with European production chains. In Estonia, industrial output, mainly manufacturing of radio, TV and communication equipment, reached record highs, as year-on-year growth accelerated from 4.2 percent the first quarter of 2010 to close to 30 percent in the fourth quarter of 2010. Growth in some EU10 countries spread to finance and real estate and strengthened trade, hotels and restaurants, and transport in the second half of the year. Public administration and community services remained subdued in light of fiscal pressures across the region (Figure 4).
While growth improved across the EU10, the recovery remained multi-speed. The upswing was mainly driven by external demand, as domestic demand was restrained by weak labor market conditions, higher commodity prices, deleveraging and the short-term effects of fiscal unwinding. Countries with the most significant overheating prior to the crisis and largest contractions in 2009, such as Latvia, Estonia and Lithuania, experienced the biggest growth improvements in 2010. As a result, growth differences across the EU10 region narrowed from almost 20 percentage points in 2009 to just over 5 percentage points in 2010. Nevertheless, country differences remained important. Slovakia, Poland — both countries with limited pre-crisis imbalances — and Estonia expanded by 3.1 percent or more (Figure 5). Strong restocking was supported by solid net exports in the case of Slovakia and Estonia, and by consumption in the case of Poland. Growth remained close to zero in Bulgaria and negative in Romania and Latvia in light of weak consumption and even weaker investment. In the other countries, growth varied between 1.2 percent and 2.4 percent, bolstered by restocking in the Czech Republic, Hungary and Slovenia and very strong restocking in Lithuania.

High frequency indicators point to a continued growth momentum in early 2011. Economic sentiment in the EU10 exceeded its long-term average of 100 in December 2010 for the first time in 26 months. However, it remained in February 2011 below 100 in Romania and Latvia, where economic activity still contracted in 2010 (Figure 6). In the EU10, industrial production continued to expand at double-digit rates, and retail sales at the brisk pace of 7 percent. In January 2011, industry grew fastest in open economies such as Estonia, Latvia, Lithuania and Slovakia, while retail sales continued to perform especially well in Poland.
Figure 5. EU10 countries annual growth rates, year-on-year, percent

Source: Eurostat, World Bank staff calculations

Figure 6. Economic Sentiment Indicator

Source: European Commission, World Bank staff calculations
Trade and External Developments

While global trade is set to moderate from the double-digit expansion in 2010, it is likely to remain a key engine of growth in the EU. Trade volumes increased strongly in Asia, driven by high GDP growth and intra-regional trade, and for commodity exporters. This helped to lift EU trade. During the last quarter of 2010, extra-EU trade increased in current US Dollar terms 18 percent. Intra-EU trade increased only 7 percent, as it is held back by weak domestic demand in a number of member countries.

The revival of global trade continues to support growth in the EU10. In 2010, imports of goods rose by 22.7 percent, largely due to higher international prices of oil and other primary commodities, and goods exports by 23.1 percent, on account of increased volume. Despite relatively strong growth, 2010 imports were still below the average level of imports in the pre-crisis year. By the end of 2010, EU10 exports had returned to pre-crisis levels, while EU10 imports trailed by some 8 percent (Figure 7). The level of exports outpaced the pre-crisis level, except in the Czech Republic, Estonia, Slovakia, Latvia, and Slovenia. The lag in the recovery of imports was biggest in countries that underwent the largest adjustments in domestic demand, including Latvia, Estonia, Romania, Bulgaria and Lithuania. Still, import growth increased steadily with the rebound in domestic demand, and was higher than export growth in five EU10 countries in January 2011 (Figure 8).

While trends in current account balances varied across the region, the overall EU10 current account deficit remained unchanged at a moderate level. Current account deficits widened
in Poland due to solid domestic demand, and in the Czech Republic due to a deterioration of the services surpluses to deficits and outflows of interest and reinvested earnings (Figure 9). They stabilized in Slovakia and Romania. In Bulgaria, the reduction in the trade deficit lowered the current account deficit from 8.9 percent of GDP in 2009 to 1 percent of GDP in 2010 (Figure 10). Latvia, Lithuania and Estonia continued to run surpluses, although at lower levels as income balances weakened. While current account deficits could widen further with strengthening domestic demand and renewed capital inflows, they are projected to stay low relative to pre-crisis.

**Figure 9. Current account balances in EU10 countries, 2008-2010, percent of GDP**

**Source: World Bank staff calculations**

Gross external debt-to-GDP ratios increased moderately, as low current account deficits and the rebound in growth compensated partly the impact of large government external borrowing. The ratio increased by 2 percentage points of GDP to close to 80 percent from 2009 to 2010 mainly due to external financing of sovereign debt (Figure 11, Figure 12). Government external debt was at the end of 2010 almost as high as bank external debt. Gross external debt-to-GDP ratios ranged from 46.5 percent in the Czech Republic to over 160 percent in Latvia.

**Figure 11. Gross external debt to GDP ratio in EU10 countries in 2009 and 2010, percent**

**Source: Central Banks, World Bank staff calculations**

**Figure 12. Structure of gross external debt to GDP ratio in 2010, percent**
Inflation and Exchange Rates

Inflation edged upwards over the last six months due to higher international commodity prices (Box 1). Headline inflation in the EU10 reached 3.8 percent in February 2011, the highest level since April 2009 (Figure 13). The rise reflects the surge in international prices of energy and food, and increases in indirect taxes and administrative prices in some member states. Energy prices rose to 9.9 percent in January 2011 in the EU10, the highest level since October 2008. This rise was particularly large in Slovakia, Latvia, Bulgaria, Poland and Lithuania. Food inflation increased to 7.3 percent in the EU10, the highest level over the last four years. Food prices rose especially strongly in Estonia, Romania, Latvia, and Lithuania since September 2010. However, core inflation, which excludes energy and unprocessed food, was 2.4 percent in the EU10, which is broadly unchanged since September 2010 (Figure 13). Negative output gaps and high unemployment continued to keep price pressures low. However, second-round effects from large increases of food and energy prices and rising domestic demand could increase inflationary pressures in some countries.

Box 1. Commodity Price Increases

On April 4, 2011, crude oil prices rose to a 30-month high in New York. Crude oil for May delivery broke through USD108 a barrel, the highest level since September 2008. Oil prices climbed about 19 percent during first three months of 2011, on the back of a 28 percent rise in 2010. The price increase is the result of stronger than anticipated demand growth, especially in China, the US and Europe; supply constraints linked to the political unrest in the Middle East; as well as a weak US Dollar. The short-term price outlook will depend mostly on the pace of the global economic recovery and OPEC supply responses.

In addition, food prices increased and were in March 2011 close to their 2008 peaks. The increase is mainly driven by weather related supply shocks. High food prices might persist in the coming months, especially if large grain importers in the Middle East and elsewhere step-up their purchases to maintain low domestic food prices.

Source: World Bank staff.

The picture is varied across the region reflecting the impact of food and energy price increases and other country specific factors. Since September 2010, prices increased most in Latvia, Slovakia, Estonia, Lithuania and Bulgaria. These are countries affected by large food price increases and/or energy price increases. In February 2011, inflation was highest in Romania, reflecting partly the impact of a VAT increase introduced in mid-2010, and is likely to decline in the second half of 2011, as the effects of the VAT hike from July 2011 taper off. Inflation is also declining in Slovenia, as the recovery remains sluggish. In February 2011, Slovenia was the only country with negative core inflation, after Latvia reported positive core inflation in the first two months of 2011.
In spite of persistent concerns over sovereign debt in some euro area countries, several EU10 currencies remained broadly stable. The euro experienced large swings to other currencies of the 20 most important trading partners. These changes were driven by shifting market sentiment over the fiscal and economic prospects of some euro area countries and the strength of the euro area recovery relative to the global economy. The euro appreciated from mid-2010 to early November 2010, depreciated until mid-February 2011, and then appreciated again. Overall, the euro remains broadly unchanged compared to its average level in 2010 in nominal effective terms. Supported by a rebound in capital flows, the Hungarian forint and the Romanian lei appreciated vis-à-vis the euro in nominal terms by 4 to 6 percent since October 2010 (Figure 14). Overall, real effective exchange rates for Poland, Hungary, Romania and the Czech Republic remain visibly below pre-crisis levels in contrast to countries with pegged exchange rates, which are close to the level from August 2008 (Figure 6).
Finance

Financial markets in the EU10 improved but vulnerabilities persist. Thanks to the economic recovery, ample liquidity and policy support, global financial markets performed well during the past six months. Risk spreads declined, lending conditions improved and equity markets increased. These improvements also lifted financial markets in the EU10. Relative to October 2010, sovereign and banking group risk spreads have declined, stock markets have risen and interbank spreads have narrowed (Figure 16). Nevertheless, financial markets in Europe remain volatile. In spite of the steady economic expansion, stepped-up fiscal consolidation in some countries, interventions of the European Central Bank and economic governance reforms in the EU, investors remain concerned about large funding needs of banks for refinancing and recapitalization and links between banking and sovereign risks in parts of the euro area.

Capital flows to the EU10 continued to recover. Gross inflows to EU10 countries amounted to close to USD10 billion in first quarter of 2011, or around 3 percent of GDP, similar to levels of the previous quarters (Figure 17). However, the composition of capital inflows changed. After equity flows increased in the fourth quarter of 2010, they moderated noticeably in the first quarter of 2011. This was in response to concerns about financial stability in the euro area periphery and the economic impact of the political changes in the Middle East as well as the Japanese earthquake and tsunami. In contrast, public bond related capital inflows increased in response to government efforts to cover their 2011 financing needs early in the year. While Poland represented more than one third of all EU10 bond issuance in 2010, Hungary accounted for close to half of all EU10 bond issuance in the first quarter of 2011. In addition, bank’s cross-border claims in the EU10 increased in the third quarter of 2010 for the first time after three quarters of decline (Figure 18), and bank related flows continued to improve in the fourth quarter of 2010 and first quarter of 2011.
While resurgent capital flows have led to signs of overheating in some emerging economies, there are few such signs in the EU10. The increase in gross capital flows in the EU10 was modest relative to other regions. For example, gross capital flows rose from USD30 billion in 2008 to USD46 billion in 2010 in the EU10, but from USD49 billion to USD144 billion in East Asia and Pacific (Figure 19). As a result, the appreciation of the exchange rate relative to the US Dollar in key EU10 markets was modest over the last two years compared to other emerging markets (Figure 20). Similarly, stock markets remained in March 2011 either close to or below pre-crisis peaks in EU10 countries, reflecting the volatility in equity flows (Figure 21).
Spreads on sovereign debt and bond yields remained stable. In spite of recurrent concerns about sovereign debt in countries of the euro area periphery, credit default swap (CDS) spreads in the EU10 remained broadly unchanged over the last nine months. This is in stark contrast to some countries in the euro area whose CDS spreads now exceed those of EU10 countries (Figure 22, Figure 23). While the correlations between average sovereign yields of some countries of the euro area periphery are high, the recent concerns about sovereign debt in Portugal did not spread to the EU10 (Figure 24). The limited degree of financial market spill-over suggests that markets discriminate between euro area and non-euro area countries.
Figure 24. EU10 government bonds’ yields correlations with Greek, Irish and Portuguese yields

Source: Reuters, Bloomberg, World Bank staff calculations
Notes: 3-month correlations

Government bond yields in the EU10 increased in line with global trends. The AAA-rated euro area and US government long-term bonds rose from end of November 2010 to March 2011 due to the positive economic outlook in these regions, rising equity prices and modest increases in long-term inflationary expectations. Similarly, bond yields in secondary market increased in EU10 countries over the last six months, but they continue to remain below the peaks of 2009 (Figure 25).

Figure 25. EU10 government bond yields

Source: Reuters, Bloomberg, World Bank staff calculations
Note: In case of Bulgaria the average annual yield of primary market on 10½-year government bond dropped from 6.37 percent in January 2010 to 6.1 percent in July 2010 and came to 5.49 percent in January 2011.

Banks’ funding pressures persisted. Spreads of major European banking groups operating in the EU10 diverged somewhat over the last six months, as they face large financing needs. Banking risks are especially high in peripheral euro area countries where financial stress interacts with fiscal pressures and low growth. In EU10 countries, non-performing loans continue to increase in some countries, making banks wary to extend credits (Figure 26).
Credit growth to the private sector remained sluggish. Growth in total credit was negative from October 2008 to January 2011 in real terms (Figure 27). Credit growth to enterprises was negative in all EU10 countries with the exception of Bulgaria. Credit growth to households performed better, but it remained negative in five EU10 countries, as households continued to deleverage. However, credit levels are set to continue their rebound from the March 2009 trough, especially in countries with solid banking sector fundamentals and strong economic prospects (Figure 28).
Jobs

One and a half years after the resumption of output growth, labor markets in the EU 10 continued to be slack. The pace of the recovery remained too subdued to generate enough jobs. After two consecutive quarters of expansion, employment growth turned negative. The number of employed workers declined from 42.4 million in the third quarter to 41.9 million in the fourth quarter (Figure 29). The picture differed across countries. The pick-up in export-led manufacturing supported an expansion of employment in the fourth quarter in Estonia, Lithuania, Slovakia and the Czech Republic. By contrast, weak economic activity, especially in constructions, led to employment losses in other countries, particularly in Bulgaria and Romania.

While job reductions from the third to the fourth quarter were consistent with the seasonal pattern, employment remained below pre-crisis levels. Over the last three years, employment in the EU10 declined by about half a million, or 1.4 percent of the working age population. Over the same period, employment in the EU15 dropped by 1.7 percent, slightly more than in the EU10, in part because the economy in the EU15 rebounded slower from the crisis than in the EU10. As a result, the EU10 managed to reduce the gap in the employment rate relative to the EU15 only by 0.5 percent over the last three years. In the fourth quarter of 2010, 64.7 percent of the working age population was employed in the EU10, compared to 69.7 percent in EU15 (Figure 30).

Among EU10 countries, losses in employment were related to the losses in output, although there important country differences. The job reductions in Bulgaria and Latvia were larger than what would be expected on the basis of the output drop. This reflects the pre-crisis overheating and ongoing structural changes in these economies. By contrast, countries such as Hungary, Romania and Slovenia managed to moderate employment losses relative to the size of the output contraction (Figure 31).
The economic recovery still bypassed the unemployed. The share of the unemployed in the labor force in the EU10 increased by 3.7 percent from the pre-crisis trough to the crisis peak and reached 10.0 percent in February 2010 (Figure 32). In December 2010, the unemployment rate remained at that level. In early 2011, some 3.5 million workers were unemployed across the EU10, some 300,000 workers more than in early 2008. While unemployment increased somewhat less in the EU15, mainly due to the strong performance of the German labor market, it remained at the crisis peak of 9.5 percent in December 2010. Among the EU10 countries, unemployment rates started to decrease from their crisis peaks only in Estonia and Latvia, the two countries with the largest percentage point increases in unemployment during the crisis. In all countries, unemployment rates remain far above their pre-crisis lows (Figure 33).
Unemployment remained especially high among the young and the unskilled. In the fourth quarter of 2010, the EU10 unemployment rate for workers aged 20 to 24 was 24 percent, about 1.5 times as high as overall unemployment. Unemployment among low-skilled was 20 percent, about twice as high as overall unemployment. Over the last three years, the crisis increased unemployment among the young especially in Lithuania, Latvia, Slovakia, Estonia and Bulgaria; and among the low-skilled in Lithuania, Latvia, Estonia and Bulgaria. Romania and Slovakia stand out as countries that succeeded in preventing increases in low-skilled unemployment (Figure 34, Figure 35). The country variations reflect factors such the severity of the output contraction, adjustments during the crisis in construction, light manufacturing and other sectors, as well as government labor market policies (see Focus Note Household and Government Responses to the Global Financial Crisis).

Persistent weaknesses in labor markets resulted in increases in long-term unemployment. With little progress in reducing the number of unemployed, and job creation still sluggish,
vacancy ratios continue to be high. The number of unemployed per job vacancy ranged from around 94 in Latvia and 51 in Lithuania to 15 in the Czech Republic. This makes it difficult for unemployed to find jobs. Long-term unemployment continued to rise in the EU10. In the third quarter of 2010, 4 percent of the labor force was out of a job for over 12 months. Only 2.5 percent of the labor force was in long-term unemployment in the third quarter of 2008. Long-term unemployment was highest in Slovakia, Latvia, Estonia and Lithuania, where it exceeded 7 percent of the labor force in the third quarter of 2010.

In spite of the recovery, enterprises are still accommodating increases in demand through increases in productivity per worker. During the crisis, firms hoarded labor in the face of steep contractions in demand, especially in the industrial sector. With the recovery, firms are boosting capacity utilization and increasing the number of hours worked per head. Hence, unemployment stays unchanged and labor productivity is improving. This is confirmed by the trend in labor productivity per worker in both the EU10 and EU15. During the crisis, the drop in output turned the growth rate of labor productivity per worker negative, as firms limited the number of lay-offs, in part by reducing hours worked per worker. Once output growth resumed in mid-2009, growth in labor productivity per worker became positive, as employment adjustments again lagged behind output changes (Figure 36).

Figure 36. Real labor productivity per person employed in EU10 and EU15, quarter-to-quarter, seasonally adjusted

![Graph showing real labor productivity per person employed in EU10 and EU15, quarter-to-quarter, seasonally adjusted.](image)

Source: Eurostat, World Bank staff calculations

Increases in wages lag behind productivity increases, helping to improve competitiveness. With the exception of the Czech Republic, the growth rate of labor productivity was higher than that of compensation per worker for the fourth or fifth consecutive quarter. Hence, the annual rate of change in real unit labor costs was negative. This should help firms to rebuild their profit margins after the losses in 2009 (Figure 37). Labor productivity growth is expected to decline over the coming quarters, as enterprises exhaust spare capacity and resume the hiring of workers. Labor demand will further increase with the opening of job markets in Austria and Germany to EU8 workers (Box 2).
Box 2. Opening of German and Austrian labor market to EU8* workers

On May 1, 2011, Austria and Germany will open their labor markets for employees from EU8 countries. Other EU15 countries had opened their labor markets for these employees already in May 2006 or May 2009, while Austria and Germany had made full use of the ‘2+3+2-year arrangement’. A similar ‘2+3+2’ scheme is in place with respect to workers from Romania and Bulgaria. A similar scheme is in place with respect to workers from Romania and Bulgaria, which means that all restrictions to workers from EU2 countries will end on January 1, 2014.

During 2004 to 2009, some 250,000 workers from EU8 countries migrated annually to EU15 countries, although the number declined during the global financial crisis. The share of EU8 workers migrating to Austria and Germany declined from 60 percent prior to 2004 to 12 percent after 2004.

With the opening of the labor markets, between 100,000 and 140,000 EU8 workers are expected to migrate to Germany each year. Poles will constitute around 45 to 65 per cent of the total. General equilibrium simulations suggest that the increase in EU8 migration would boost Germany’s GDP by 2020 by about 1.2 percent, lower wages by 0.4 percent and increase unemployment by 0.2 percent. Economic activity would expand especially in industry and selected services, including hotels and restaurants.


Notes: EU8 refers to countries which joined the EU in May 2004, i.e. Poland, Lithuania, Latvia, Estonia, the Czech Republic, Slovakia, Hungary and Slovenia.
Prospects

After the rebound from the crisis in 2010, global growth is projected to slow somewhat in 2011. In spite of improving financial markets and additional fiscal support in the US and Japan, growth in advanced economies is likely to remain subdued as strengthening private demand is offset by fiscal consolidation and the end of the inventory cycle. Emerging economies, led by Asia, are set to stay buoyant due to strong domestic demand. Growth in the EU is likely to remain broadly unchanged, as solid world trade and good EU business sentiment are balanced by continued tensions in EU financial markets.

Growth in the EU10 is set to strengthen (Figure 38). The pace of the recovery in the EU10 is likely to accelerate once firms raise investment and households step up consumption in response to a better external environment and normalized financial conditions. Close market integration with the EU15, competitive production costs, skilled workers and innovative entrepreneurs are set to lift growth in the EU10 from 2.1 percent in 2010 to 3.1 percent in 2011 and 3.8 percent in 2012. Growth in the EU15 is projected to remain stable around 1.7 percent, which is close to its potential rate. Weaker growth in Germany and fiscal consolidation across the EU15 are offset by stronger growth in other EU15 countries. Hence, the growth differential of the EU10 relative to the EU15 could increase to 2 percentage points in 2012, ensuring that convergence to average EU living standards proceeds (Figure 39).

The pace of the recovery differs across the EU10, reflecting, among other factors, the overheating prior to the crisis, trade openness and competitiveness (Figure 40). The performance of Slovakia and Poland is set to remain solid thanks to limited pre-crisis imbalances, strong integration in European production networks, EU funds, and, in the case of Poland, stable consumption. Estonia, Lithuania and Latvia are likely to build on the export-led upswing, and growth could improve to about 4 percent by 2012 as domestic demand continues to recover. Romania and Bulgaria, where the crisis hit later than elsewhere, are set to see the biggest improvements in growth in 2011, aside from Latvia and Lithuania. Growth in Slovenia, the Czech Republic and Hungary could increase to about 2.5 percent to 3 percent by 2012. This is somewhat less than elsewhere in the region, in part because these countries have already converged more to EU income levels.
While output in the EU10 had returned to the pre-crisis level in early 2011, the recovery is weak. First, the EU10 took nine quarters to reach the output level of the fourth quarter of 2008, the pre-crisis peak. Second, the growth advantage of the EU10 to the EU15 is likely to remain around 2 percentage points in the coming years compared to 2.5 percentage points during 1993 to 2008. Pre-crisis growth rates partly reflected overheating and are therefore no valid guide for sustainable growth rates post-crisis. In addition, the global financial crisis has harmed the supply potential of the EU10 economies through lower capital flows, restrained investment, possibly higher structural unemployment and lower total factor productivity growth due to credit constraints and higher risk aversion. By contrast, the crisis had less impact on the potential growth of the EU15, where growth was less reliant on capital flows. Aging is set to lower potential growth over the longer run in both the EU10 and EU15 (Figure 41).

Weak domestic demand is still holding back growth. By the end of 2010, only exports had recovered to pre-crisis levels, benefiting from the strong rebound in global trade. Exports remained far off the pre-crisis peak only in Slovenia, as the competitiveness of Slovenia’s labor-intensive exports has deteriorated. While consumption across the EU10 was also close to pre-crisis levels, it stayed noticeably below pre-crisis levels in Latvia, Estonia, Lithuania, Romania, Hungary and Bulgaria. These countries underwent large adjustments in domestic demand during the crisis, and consumption is held back by a combination of lower household net wealth, higher unemployment, and tight credit. Investment remained far below pre-crisis levels across the EU10. The only exception is Poland, where EU funds and public investment in the run-up of the Euro 2012 football championship bolstered spending on transport and other infrastructure. Private investment remains weak across the EU10 in view of deleveraging, the winding down of large construction projects, and tight international financial conditions.
Figure 41. Recovery in output, exports, gross fixed investment and final consumption from pre-crisis peak to 2010, index, peak = 100

Source: Eurostat, World Bank staff calculations

Notes: Pre-crisis peak refers to the best four quarters moving average within the period 2006-2008. Recovery for output shows also forecasted output levels in 2011 and 2012.

Uncertainty prevails, as euro area sovereign debt markets remain volatile, international prices of energy and food increase, Japan is grappling with the natural disaster, and the Middle East is undergoing political change. The deep market integration of the EU10 implies that the outlook hinges crucially on developments in Europe and elsewhere. On the upside, the policy relaxation measures in the US, the reconstruction efforts in Japan (Box 3), buoyant emerging market growth could lead to a higher-than-expected investment and growth in the EU10. On the downside, very large levels of sovereign financing needs in advanced economies could lead to disruptions in sovereign debt markets, especially if markets are not convinced about the credibility of medium-term fiscal consolidation plans. In addition, investors, wary of possible external default risks in view of high and concentrated cross-border financial exposures, could adjust their portfolios in favor of safe heaven currencies. Higher oil prices could also derail the recovery in oil-importing economies, including the EU, although the reduced dependence on oil and increased wage flexibility makes a return of stagflation unlikely. Finally, the simultaneous fiscal tightening in several advanced European countries could moderate growth more than estimated in the next years.

Box 3. EU10’s Contagion Risks from Japan’s Earthquake and Tsunami?
On March 11, 2011, the northeastern part of Japan was hit by an earthquake and a tsunami. It left almost half a million people homeless and more than 10,000 people may have lost their lives. However, judging from the experience during past catastrophes, the impact on Japan’s GDP is expected to be limited. While economic activity is likely to slow down in the second quarter of 2011 due to power outages and other disruptions, GDP is expected to rebound as early as the second half
of 2011, buoyed by reconstruction efforts. In the coming months, economic activity could slow down in Asian countries with close trade and financial links to Japan. However, the direct impact on the EU10 region is likely to be minor:

- In 2010, Japan accounted for 1 percent of EU10 imports. Japan’s import share was highest in Hungary (2.2 percent), and lowest in Slovenia (0.4 percent).
- In 2010, Japan accounted for 0.3 percent of EU10 exports. Japan’s export share was highest in Hungary (0.6 percent), and lowest in Slovenia (0.1 percent).
- At the end of September 2009, foreign claims of Japanese banks amounted to 0.8 percent of all foreign bank claims on ultimate risk basis. The share was highest in Poland (1.6 percent) and lowest in Estonia (0.0 percent).
- In 2009, total direct investment from Japan amounted to 0.8 percent of total foreign direct investment to the EU10. The share was highest in Poland (0.9 percent) and lowest in Latvia (0.0 percent).
- In 2009, Japanese holdings of portfolio debt securities amounted to 5.3 percent of overall portfolio debt securities in the EU10. The share was highest in Poland (9.8 percent) and lowest in Estonia, Latvia and Romania (0.0 percent).

Figure 42. EU10 trade relations with Japan, exports and imports in 2010, percent of total

Figure 43. EU10 banking sector links to Japan, share of Japanese banks’ claims in total foreign claims, September 2010, percent

Source: Eurostat, World Bank staff calculations

Source: BIS, World Bank staff calculations

Figure 44. Japan’s FDI in EU10 countries, percent of total FDI in 2009, percent

Figure 45. Japan’s portfolio investment in EU10 countries, percent of total portfolio investment in 2009, percent

Source: IMF, Coordinated Direct Investment Survey (CDIS), World Bank staff calculations

Source: IMF, Coordinated Portfolio Investment Survey (CPIS), World Bank staff calculations

Source: World Bank staff.