POST COVID-19 RECOVERY AND NEW CHALLENGES FOR CENTRAL AND EASTERN EUROPEAN COUNTRIES

Gergana Mihaylova-Borisova[1]

Abstract: *Following the severe pandemic crisis related to the spread of a new virus to humanity, the coronavirus COVID-19, economies are beginning to recover at different rates depending on the extent to which they have been affected by the crisis. The aim of the study is to analyse to what extent the Central and Eastern European (CEE) countries have been able to recover from the pandemic crisis and reach pre-crisis levels of their main economic indicators. Despite the successful recovery of most of them, the countries face new challenges posed by a number of internal and external factors such as accelerating inflation, expansionary monetary policies of central banks, declining bank profits as a result of increased costs, and the outbreak of war between Russia and Ukraine.*

Keywords: *economic growth, monetary policy, pandemic crisis, CEE countries*
JEL: *E22, E23, E31, E58*

1. Introduction

After a series of crises over the past two decades, in 2020 the whole world faces a new challenge posed by the spread of a new deadly and unknown virus to humanity. This gives rise to another crisis, the so-called pandemic crisis, which differs significantly from previous financial, banking, currency and debt crises, having a direct effect on specific markets and the economy as a whole. Initially, this crisis does not affect economies because of its nature. This crisis is a health crisis, a crisis affecting the health and lives of many people. However, in order to limit the spread of this deadly virus and to protect the lives of people all over the world, a number of measures are being taken, limiting direct communication and people meeting in one place, closing many businesses, digitising economies so that they can continue to function in a pandemic environment. This inevitably has an impact on the economic development of countries around the world, including those in CEE. Gradually, as the strength of the coronavirus weakens, people's lives are normalising, economies are beginning to recover and to report positive economic growth rates, after the negative ones reported at the end of 2020 because of the pandemic crisis. However, to what extent are economies able to recover from the pandemic crisis and are new obstacles to their economic development emerging?

This study seeks to analyse to what extent CEE countries have been able to recover from the pandemic crisis and to identify new obstacles and challenges to their further recovery.

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The countries covered are Bulgaria, Romania, Slovakia, Slovenia, Hungary, Czech Republic, Poland, Estonia, Lithuania and Latvia. The period of analysis is from 2018 to 2022 to cover the period before and after the pandemic crisis. Official statistical information, published by the Eurostat, is used.

The study argues that CEE countries have been able to recover from the COVID-19 crisis and maintain higher growth rates compared to the EU average. Convergence to the EU, the monetary regimes in place and the monetary policy applied, also taking into account the specificities of the economic development in most of them, as well as the attracted investments have positively influenced this. However, a number of external factors are confronting Central and Eastern European countries with new challenges, which will affect their future economic development.

The study is structured in several parts. In the second part, a literature review is carried out in relation to research on the economic development and factors for the economic growth in CEE countries. In the next part, the post-crisis recovery of Central and Eastern European countries is analyzed by examining the dynamics of several macroeconomic indicators such as economic growth, unemployment rate, consumption, investments and industrial production. The last part outlines the main challenges faced by the CEE countries.

2. Review of the literature

In reviewing the literature on the economic development of CEE countries, two groups of studies can be distinguished. The first group of studies includes those that are devoted to the economic development of an individual CEE country (Chobanov, 2019; Reichardt, 2011; Borisov, 2021a).The second includes studies that analyze economic development for the whole set of countries or several countries of CEE or look for the economic development determinants and/or the relationship of GDP growth with banking sector development for the countries covered (Pece et al., 2015; Yemelyanova, 2021; Umantsiv and Ishchenko, 2017; Pokrivcak et al., 2016; Setiawan et al., 2021; Borisov, 2022).

Pece et al. (2015) examine and estimate the determinants of long-term economic growth in three CEE countries - the Czech Republic, Poland and Hungary - using country-specific regression models. The authors demonstrate a positive relationship between innovation and economic development in the countries under consideration, using a number of indicators such as R&D expenditures, number of patents, etc. to capture innovation. The time period is from 2000 to 2013, covering also the period of the financial crisis.

A study of the relationship between the development of capital markets, the banking sector and economic growth in CEE countriesis done by Yemelyanova (2021). The researcher assesses the direction and strength of the relationship between financial development and economic growth for two periods 1999-2012 for 8 CEE countries (Hungary, Poland, Lithuania, Latvia, Estonia, Slovakia, Czech Republic, Slovenia) and for the period 1999-2015 for 5 CEE countries (Slovakia, Czech Republic, Hungary, Slovenia, Poland). It is shown that there is an impact of both capital market development on the economic development of CEE countries and banking system development on economic performance for the period 1999-2015. However, the relationship between domestic credit to the private sector and economic growth in the countries studied is negative, which is explained by the financial crisis in 2007-2008.

Umantsiv and Ishchenko (2017) analyze the banking sector in several Central and Eastern European countries, namely Romania, Poland, Bulgaria, Ukraine and Belarus. The authors also investigate the role of the banking sector in the economic development of the analysed countries. The results of the banking sector analysis show both similarities and differences in the development of the banking sector in these countries. The positive relationship between real sector development and banking investment is also highlighted.

Setiawan et al. (2021) also examine the relationship between financial sector development and economic growth in ASEAN and CEE countries over the period 2002-2019. They argue that economic growth is influenced by the development of capital markets, and therefore recommend that policymakers should support the development of financial markets.

When analyzing the economic development of CEE countries, it is striking that a part of them refers to the performance of the countries during the global financial crisis of 2007-2008 and the post-crisis recovery from this crisis (Yemelyanova, 2021; Kozub-Idzkowsk et al., 2011; Badulescu et al., 2019; Brada et al., 2021; Curea et al., 2019; Miklaszewska and Kil, 2016; Nenovsky et al., 2010;). Among the diversity of studies, however, few stand out in the post-crisis recovery of Central and Eastern European countries from the COVID-19 crisis (Brada et al., 2021).

Kozub-Idzkowsk et al. (2011) analyse key macroeconomic indicators characterising the CEE countries, summarising the reasons for the crisis and the anti-crisis measures in these countries. It is found that the main causes of the crises in these countries after the financial crisis in the United States are external, such as the high dependence on capital in countries like Romania, Bulgaria and the Baltic countries, the decline in exports and the relationship with foreign banks. Of course, there are also internal factors for the crises, such as the rapid increase in wages, credit bubbles, high budget deficits, and weak institutional systems.

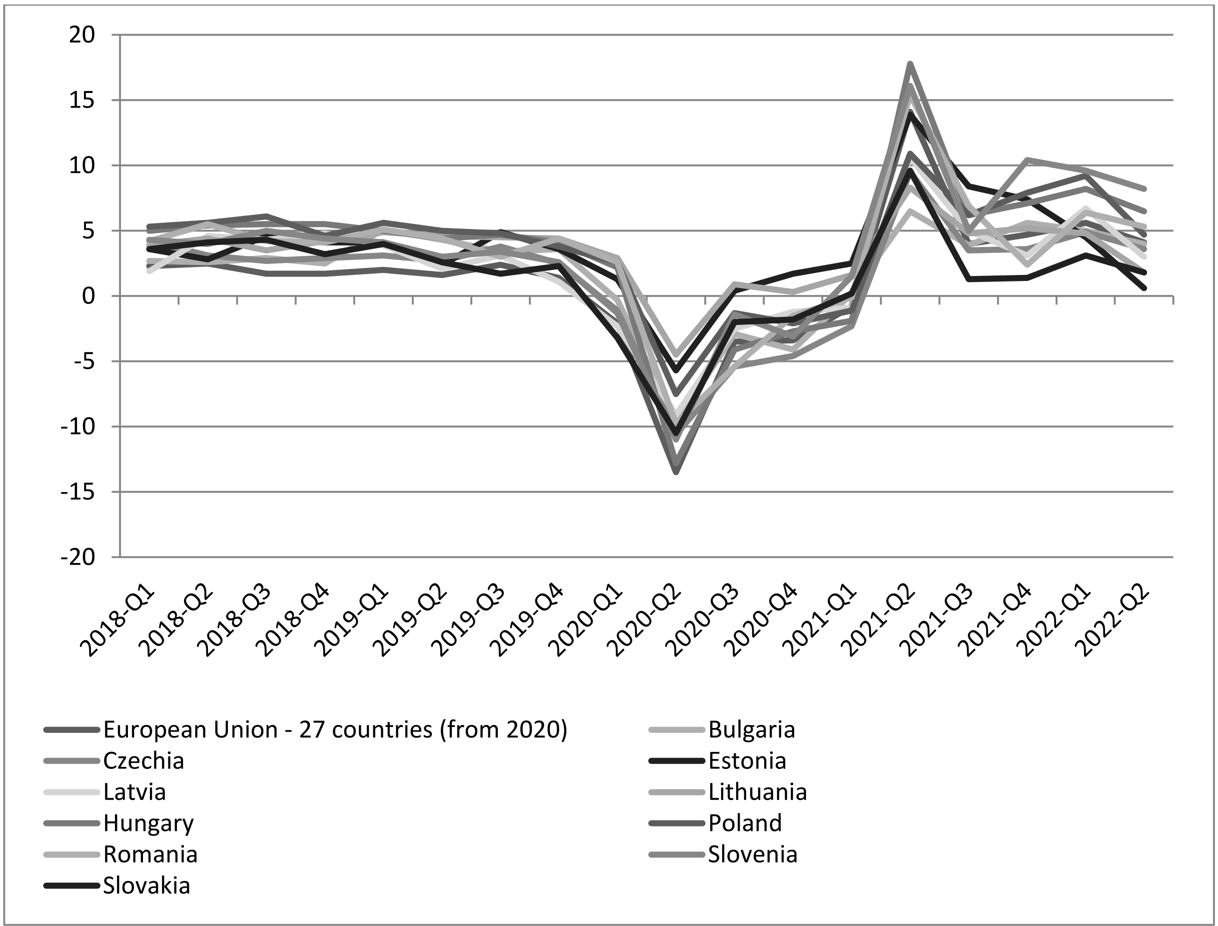
Given the limited research on the impact of the 2020 pandemic crisis on CEE countries, this study focuses specifically on the post-crisis recovery of CEE countries and identifying the main challenges they face.

3. Recovery from the COVID-19 crisis in CEE countries

To analyse the degree of recovery of the CEE economies, a set of indicators is used, such as real GDP growth, unemployment rate, consumption, investments and industrial production.

When tracking the dynamics of real GDP growth in the CEE countries, there were no significant deviations in the growth rates of individual countries before the crisis (Figure 1). Economic growth in the second quarter of 2019 was lowest in Latvia (2.1% annual growth) and highest in Poland (5% annual growth). The pandemic crisis and the closure of economies to stop the spread of the virus led to a more substantial performance differences among the CEE countries, with the highest decline reported by Hungary (12.8% annual decline in Q2 2020) and the lowest in Lithuania (4.5% annual decline in Q2 2020) and Estonia (5.7% annual decline in Q2 2020).

Figure 1. GDP growth rate, real, annual, %

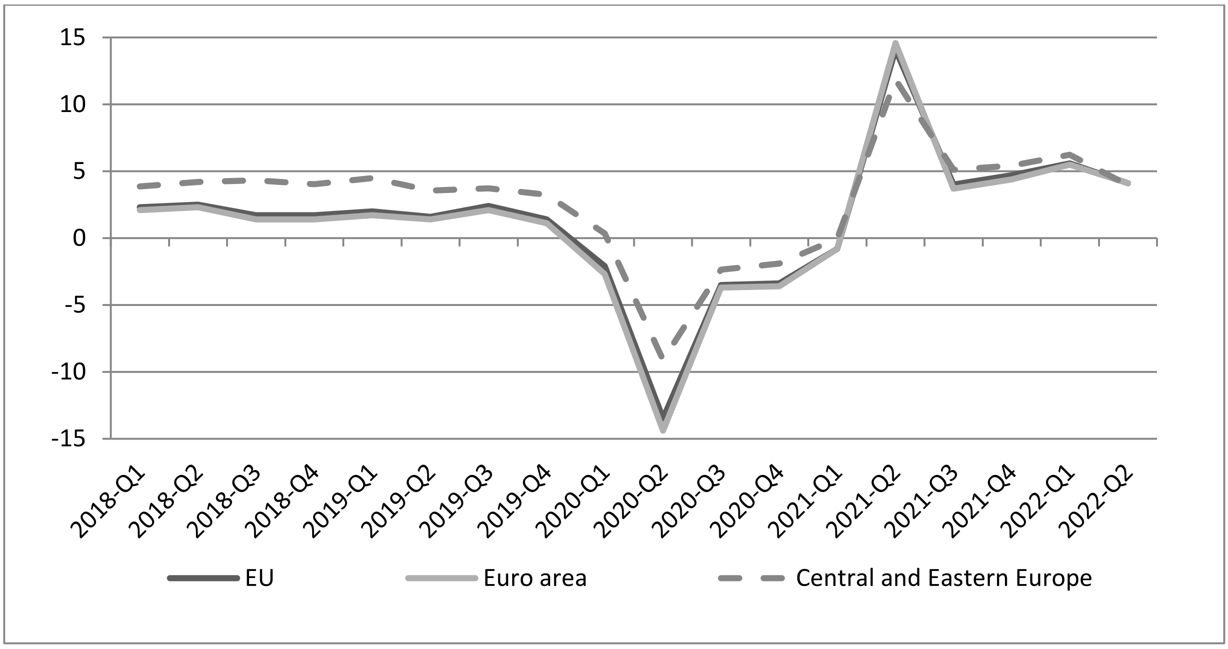


Source: Eurostat

With the loosening of restrictions and the opening up of economies in the second quarter of 2021, economies are recovering, but it is the countries with the biggest decline in the previous year that are more likely to grow because of the low base recorded a year earlier. The post-crisis recovery in CEE is characterised by larger differences in the economic performance of countries compared to the pre-crisis period. The difference in economic growth performance in the second quarter of 2022 ranged from 0.6% growth in Estonia to 8.2% in Slovenia.

Comparing the achieved economic growth in CEE countries on average with EU and Euro area countries, it is found that they also managed to maintain higher economic growth rates in the post-crisis period as well as in the pre-crisis period (Figure2). This is due to convergence and the need for these countries to converge more rapidly with EU countries in terms of income and prices.

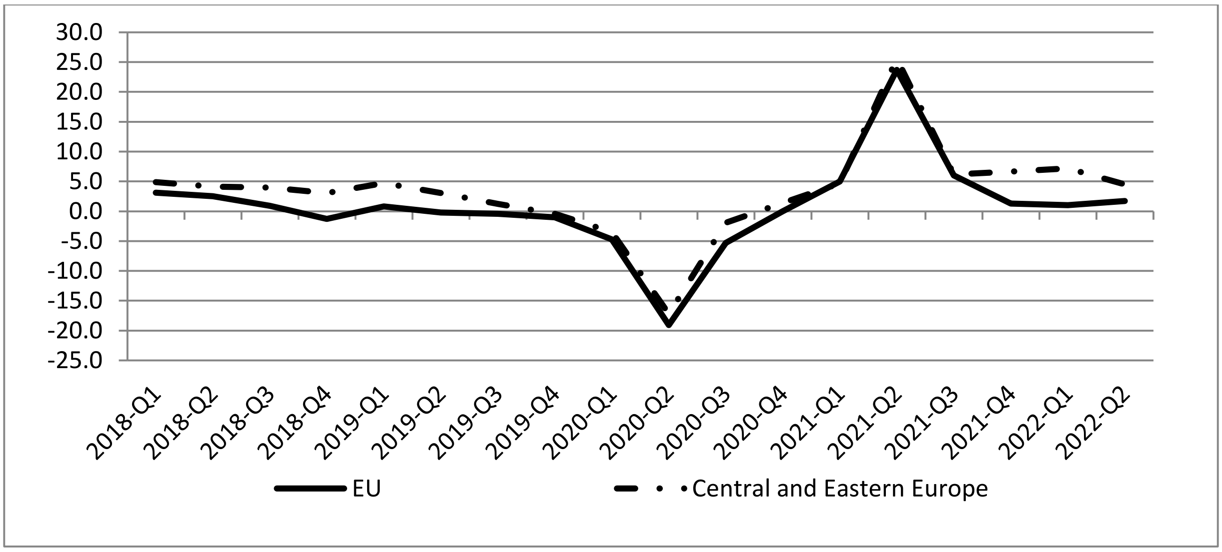
Figure 2. GDP growth rate in the EU, euro area and CEE countries, %



Source: Eurostat, own calculations

Economic growth in the post-crisis period in CEE, which has been higher than in the EU, has also been boosted by the faster recovery of industry in the post-crisis period. In CEE countries, industry grew at an average annual rate of around 7% in the recovery quarters, compared to an average growth rate of around 4% before the pandemic crisis (Figure 3). The pandemic had a positive impact on some industry sectors such as basic pharmaceuticals, coke and refined petroleum products, textile industry.

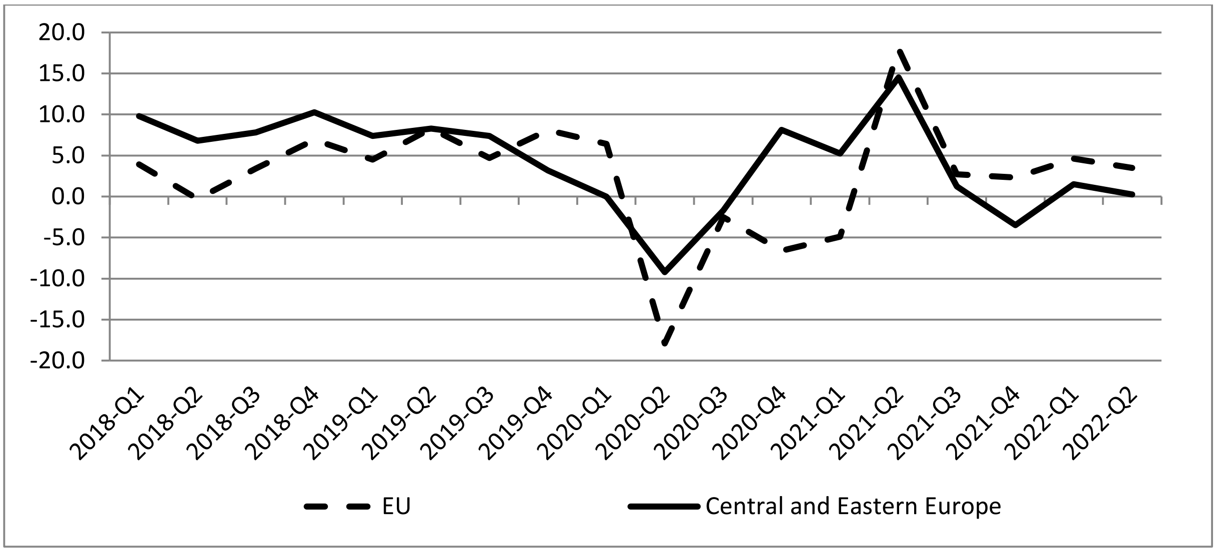
Figure 3. Industrial production, % change, y/y



Source: Eurostat, own calculations.

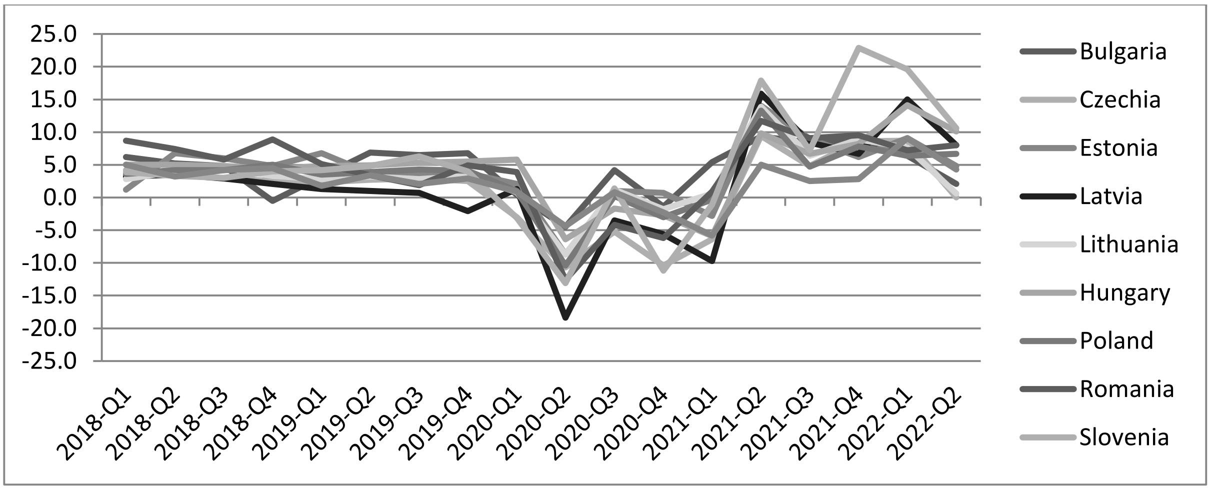
In the second quarter of 2022, however, the average economic growth in CEE is reported to be lower than the EU and euro area average. This weaker performance is due to a substantial contraction in fixed capital investment in the second quarter of 2022 in Central and Eastern European countries, where it grew by only 0.2% year-on-year, while in EU countries the reported average growth was 3.5%, marking a slight decline of 1.1 percentage points from the previous first quarter of 2022 (Figure 4). Household consumption also contributed to the slowdown in economic growth in CEE countries in Q2 2022, with all countries except Romania and Poland reporting a decline of more than 5 percentage points in household consumption growth in Q2 compared to Q1 2022 on an annualised basis (Figure 5). Countries are reaching consumption growth rates below those recorded in the pre-crisis years, partly due to household incomes being constrained by rising inflation rates.

Figure 4. Gross fixed capital formation, % change, y/y



Source: Eurostat

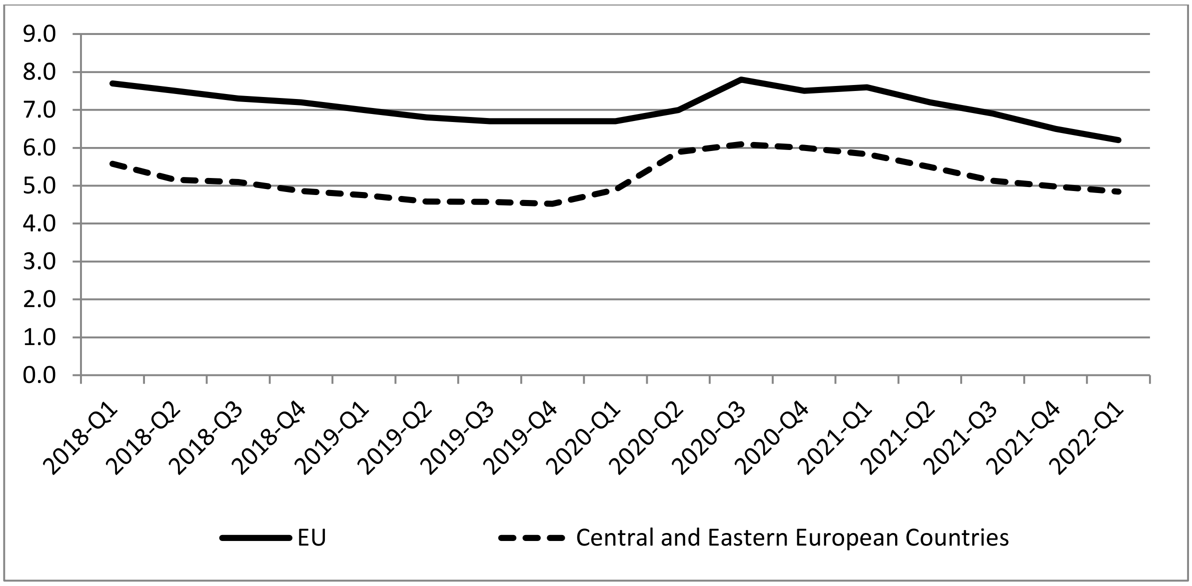
Figure 5. Fixed consumption expenditures of households, % change, y/y



Source: Eurostat

The better performance of CEE countries in terms of economic growth is also associated with lower unemployment rates. Unemployment rates in these countries before the COVID-19 crisis were below 5%, which is very close to the understanding of a natural rate of unemployment (Figure 6). Economies are using their potential to produce more and to converge more rapidly to EU countries. In the pandemic crisis, unemployment increased not only in the EU but also in the CEE countries due to the closure of businesses and economies, but unemployment remained much higher in the EU countries. In the post-crisis recovery, the gap between the average unemployment rate for EU countries and CEE countries is narrowing, which is also consistent with economic growth figures.

Figure 6. Unemployment rate, %



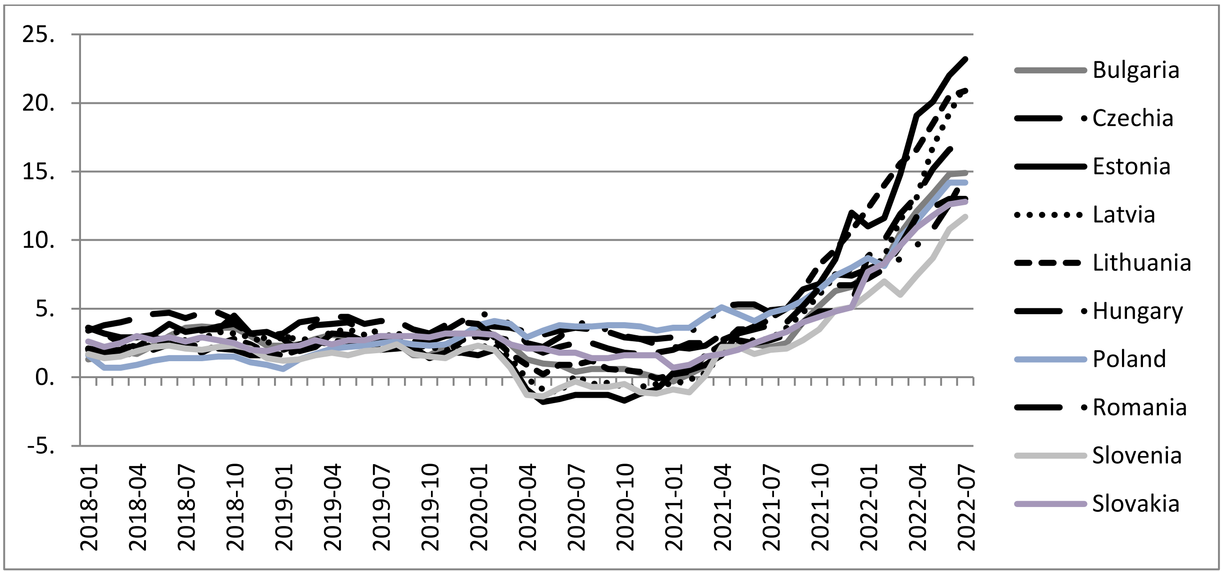
Source: Eurostat, own calculations

4. New challenges

The post-crisis recovery of the CEE countries is faster than that of the EU underlined in the analysis of data on economic growth, industrial production, unemployment. But, in the last quarter of 2022, the countries of Central and Eastern Europe face new challenges, as does the whole world.

On a global scale, the outbreak of war between Russia and Ukraine is leading to a significant restriction of trade relations between countries in the world, including between Russia and Europe, due to the sanctions imposed by the EU and the US against the aggressor. This is also affecting the growth of CEE countries, which for the first time recorded lower growth than the EU average in the second quarter of 2022. These are countries that are heavily dependent on imports of energy raw materials and products such as gas and oil. The suspension of gas and oil supplies from Russia as a countermeasure by Russia against the sanctions imposed is leading to a significant rise in the prices of these energy raw materials in Europe, and to a greater extent in the countries of CEE. In the absence of alternative sources of energy raw materials and the need for more time to diversify sources, energy prices are rising dramatically, which is putting CEE countries into shock. The countries with the highest inflation in August 2022 are Estonia, the Czech Republic, Latvia Lithuania and Bulgaria, where year-on-year inflation reaches 25.2%, 17%, 20.8%, 21.1% and 15% respectively (Figure 7). These are inflation rates not reached since the transition to a market economy in these countries. The situation is similar in large economies such as the US, the UK, where as early as the end of 2021 inflation rates are reaching levels that have not been seen in the last 30-40 years (Borisov, 2021b).

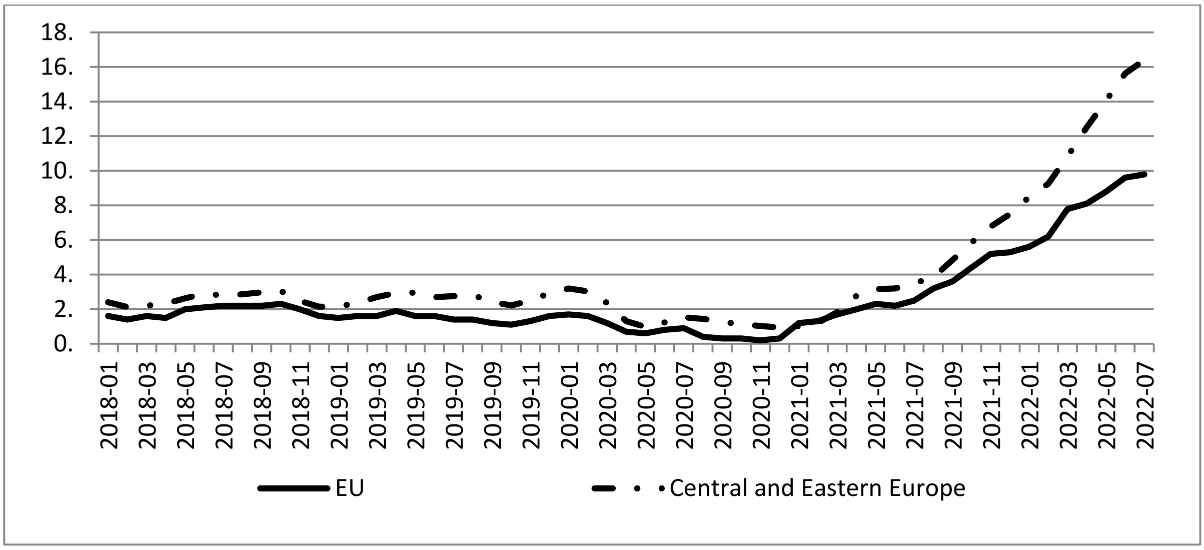
Figure 7. Inflation, HICP, %



Source: Eurostat, own calculations

When comparing the average inflation in the CEE countries and the EU countries, the acceleration of inflation in the first group of countries is more significant. It is this rising inflation in CEE countries that presents them with new challenges for their economic development. This also calls into question not only the nominal convergence, but also the real convergence of some of the CEE countries that have not yet joined the euro area. It should be borne in mind that this inflation is not only due to the incorrect policies of the central banks in these countries or the monetary regimes applied, because inflation is not only caused by the central banks' overly expansionary monetary policy, but also by external factors such as the war between Ukraine and Russia and the limited supply of energy raw materials.

Figure 8. Inflation in EU and Central and Eastern European countries, %



Source: Eurostat, own calculations

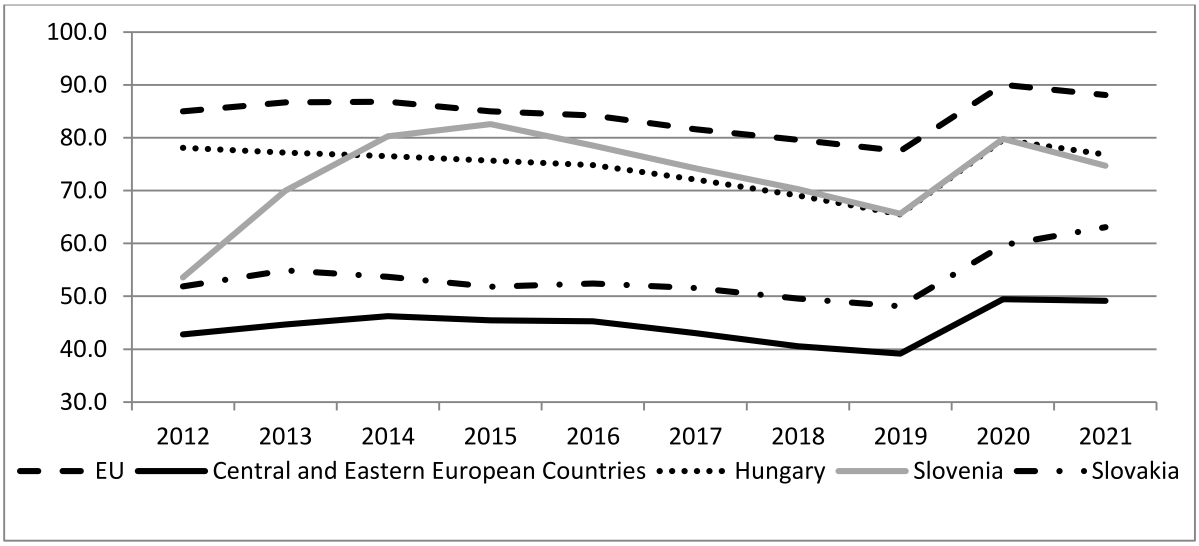
Often, accelerating inflation in countries like Estonia and Lithuania, for example, is associated with the departure of a hard monetary regime under strict rules - a currency board that contributes to stabilising inflation and bringing it from the anchor country. Estonia and Lithuania became members of the euro area by leaving the currency boards introduced in the early 1990s (Nenovsky et al., 2001), and succeeded in stabilising their economies after severe financial crises (Fabis and Rodic, 2013). In the current situation, however, accelerating inflation is not associated with these countries leaving the currency boards and joining the euro area. If that were the case, why is Bulgaria, which is currently in a currency board, also reporting some of the highest inflation rates that are not commensurate with the EU average of 10.1% in August 2022?

Before drawing any conclusions on whether the monetary regime and central bank actions have led to an increase in inflation, price increases of major groups in the consumer basket should be tracked. Central bank actions at the onset of the pandemic crisis were aimed at injecting additional liquidity through asset purchases in certain markets (Mihaylova- Borisova, 2021a; Mihaylova-Borisova, 2021b), with excessive liquidity injections leading to some acceleration in inflation since the second half of 2021. But, in 2022, additional external factors influence the accelerating inflation, which reaches over 20% in some countries. In the consumer basket of Estonia and Lithuania, there is a substantial increase of over 100% y-o-y in electricity prices, leading to a significant increase in inflation.

Another challenge countries face is the need to change the course of central banks' monetary policy. While after the global financial crisis, the question was whether countries would fall into a deflationary spiral (Mihaylova-Borisova, 2016), after the pandemic crisis, the question was whether the countries would fall into an inflationary spiral and how this inflation should be contained. After the global financial crisis, leading central banks such as the ECB and the Fed launched massive asset purchase programs in various markets and cut interest rates to stimulate countries' economies by increasing incentives for lending and investment. In the current situation of accelerating inflation, central banks are starting to raise interest rates after more than ten years at zero interest rates. These actions have been taken by the ECB, the Polish Central Bank, the Hungarian Central Bank and the Romanian Central Bank, and the countries' banking systems will be faced with the need to increase the cost of providing credit, which will also affect their volumes, and hence, additionally, consumption, investment and economic growth, which is already slowing significantly. The risk of the CEE countries falling into recession is very high, with investment growth reported at almost zero already in the second quarter of 2022.

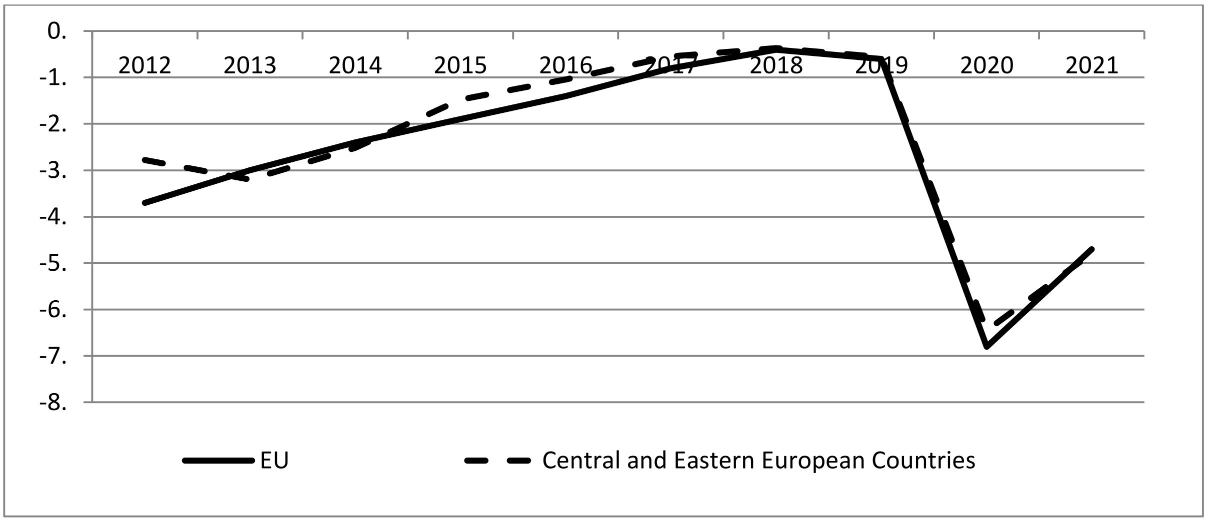
Last but not least, the high levels of government debt and the budget deficits realised in the CEE countries have to be taken into account. High levels of government debt in some countries such as Hungary, Slovenia and Slovakia (Figure 9) and rising interest rates will lead to higher debt servicing costs for these countries, which in turn puts greater risk and pressure on the realised budget deficits of these countries, which are above 5% of GDP in 2021.

Figure 9. Government debt, % of GDP



Source: Eurostat, own calculations

Figure 10. Government deficit, % of GDP



Source: Eurostat, own calculations

5. Conclusions

The study analysed the economic development of CEE countries, namely Bulgaria, Romania, Slovakia, Slovenia, Czech Republic, Hungary, Poland, Estonia, Lithuania and Latvia. The period of analysis is from 2018 to 2022, for the purpose of covering the period before and after the pandemic crisis.

The analysis showed that the CEE can recover from the pandemic crisis and reach their pre-crisis levels of key economic indicators. Convergence towards the EU, the monetary regimes in place and the monetary policy applied, which also takes into account the specificities of the economic development of most of them, as well as the attracted investments have positively influenced this. However, a number of external factors, such as accelerating inflation, expansionary monetary policies of leading central banks, the outbreak of the war between Russia and Ukraine, present the countries of CEEe with new challenges, which will affect their future economic development. The first signs of the looming recession are already visible with the registered significantly lower GDP growth in the CEE countries. The need to tackle rising inflation globally, including in the CEE countries, will inevitably push countries to the brink of recession.

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