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Which Growth Model for Central and Eastern Europe after the Crisis?

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Which Growth Model for Central and Eastern Europe after the Crisis?

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This Policy Brief discusses the growth prospects of the Central and Eastern European (CEEC) region following the current economic crisis. It argues that the 'integration model of growth' of the CEEC region was characterised by a very high degree of external liberalisation. In one group of economies (mostly the Central European economies) the model turned out to be successful in that it did not generate strong structural imbalances (in trade and current accounts and in growing private sector savings-investment gaps) prior to the crisis. This was quite different in the other group (mostly the Baltic states and the countries in Southeastern Europe, SEE) where unsustainable imbalances developed in part traced back to historical weaknesses of the tradable sectors and in part to choices of exchange rate regimes, to the importance of remittances and to missing instruments to deal with cross-border financial market integration. The analysis suggests a number of factors which will characterise post-crisis conditions in CEECs (such as increased savings rates of the household sector, deleveraging, more restricted fiscal policy space, etc.) and in external factors (lower growth in the most important Western European export markets, more difficult effective entry conditions to the EMU, etc.) and discusses an adjusted policy agenda.

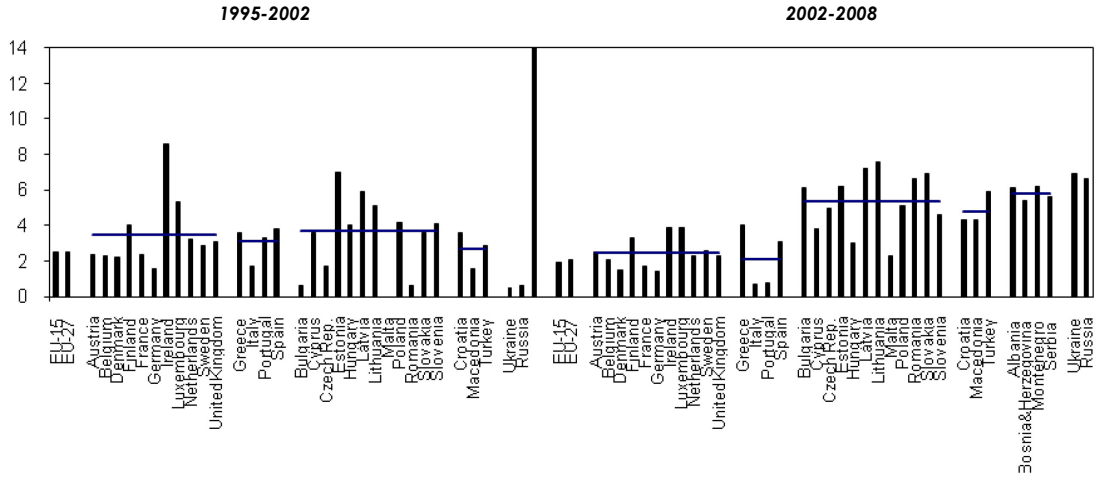
1. Introduction

The prospects of integration with the European Union drove the reform and 'transition' processes in Central, Eastern, and South-Eastern Europe (CESEE) and even in some of the neighbouring countries and regions with much more limited prospects for membership. This vision provided an important 'focusing device' for policy makers and the public alike in initiating institutional change, following certain concepts in economic policy design and affecting economic and other behavioural change. This has led to a growth model based on integration with the EU-15 that supported sustained 'catching-up' in productivity and income levels (see Figure 1), although it was interrupted in some CESEE countries by 'secondary transition crises' in the 1990s .

The international financial and economic crisis which erupted in full after the collapse of Lehman Brothers in September 2008, interrupted the stability of the catching-up processes in CESEE economies. This Policy Brief shall concentrate on the prospects of resumption of growth and on the type of 'growth model' one can envisage for the region. The challenge in a discussion of a 'new' or 'redirected growth model' is two-fold: First, we have to make sure we understand whether the conditions for growth in CESEE have changed at all and over which time horizon. For the purposes of the analysis in this Policy Note we shall distinguish quite carefully the challenges for the short run (i.e. how to get growth going again) from those in the medium to longer run (i.e. a horizon beyond the next three to four years) and relate these to expected behavioural adjustments occurring both within the countries of the region in the wake of the current economic crisis as well as to changes in the external environment. The second challenge refers to capturing the differentiation across the countries of the region, as it emerges very clearly that different countries and country groups both followed different paths prior to the crisis and face different challenges in the wake of the crisis. These issues will occupy us in Sections 2 to 4. In the final Section 5 we discuss the policy agenda required by the situation which arose from the crisis.

Figure 1: GDP at constant prices

Average annual growth rates, 1995-2002 and 2002-2008, in %



Source: wiiw Annual Database incorporating national statistics, Eurostat.

2. A 'new growth model' in the making

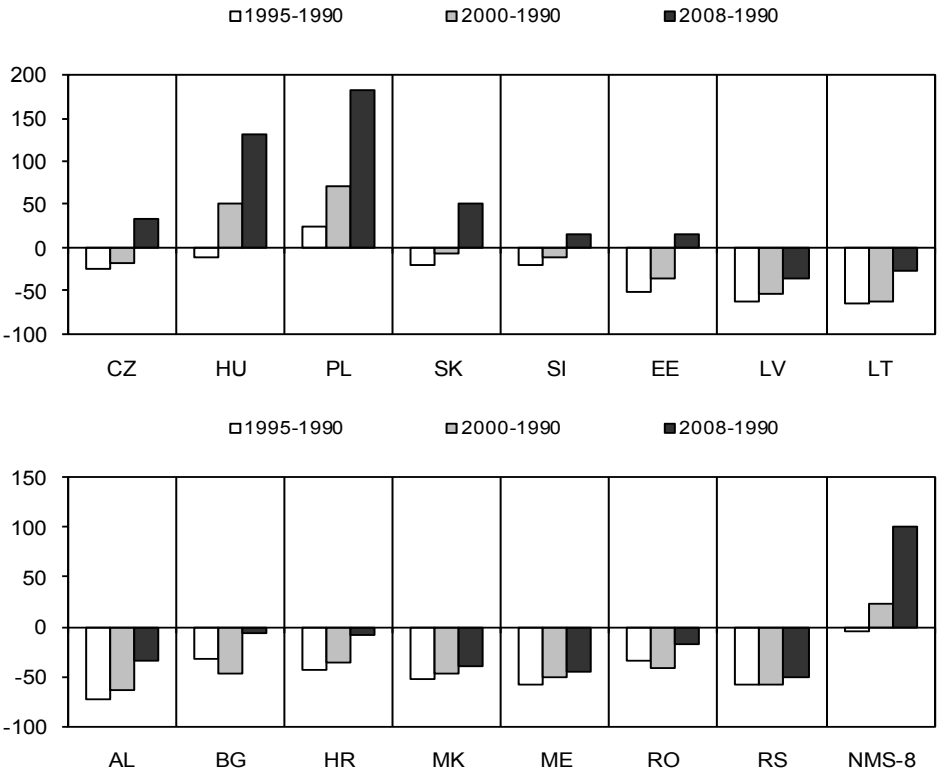
Taking up the issue of a 'new growth model', we must delineate first what characterized the 'old model' in order to understand which features are likely to change as a result of either changed characteristics and reactions of market participants resulting from the crisis or because policy makers face different constraints and embark on a change in their interventions.

The older growth model was accompanied and in parts determined by a fast attempt to reach candidate and then membership status of the EU as quickly as possible: an up-shot of this attempt was the choice of a model of 'catching-up' which adopted a very high degree of liberalization in external (and internal) economic relations. Trade was liberalized, there was a commitment to free international capital movements (in all its forms) and financial markets were opened up to foreign financial institutions. Foreign banks attained in most countries of the region dominant market positions.

Liberalization and openness in external economic relations coincided with a classic process of 'convergence', i.e. CEE economies embarked on a growth path with rates substantially above those of their Western neighbours even though such catching-up processes were at times (e.g. Czech Republic and Slovakia in the late 1990s, Poland in the early years of the 2000s, Hungary after that) interrupted by policy mistakes (such as too early peg in the exchange rate, at times mistakes in monetary policy or profligate fiscal spending) or by misalignments in wage and productivity dynamics.

Figure 2: Industrial production

cumulative change, 1995-1990, 2000-1990, 2008-1990



Note: ME; RS data for 1995-1990 refer to CS

Source: wiiw Annual Database incorporating national statistics, Eurostat.

Over the period 2002-2008 (see Figure 1) all CESEE economies experienced significantly higher growth than countries in Western Europe. Underlying this growth performance is the scope of any lower income, lower productivity economy to benefit from technology transfer (to be interpreted in a wider sense including the adoption of better organizational practices, improvements in institutions and behavioural practices) which is the main driver behind 'convergence' processes. Comparative growth accounting exercises (see e.g. World Bank, 2008) show that growth in TFP (total factor productivity) was by far the dominant factor explaining overall growth (see Box 1). In the case of the CESEE economies the speed of such 'technology' transfer was strongly supported by the anchoring in pre-accession and accession arrangements with the EU. This anchoring supported the fast and substantial influx of foreign investors which acted as important conduit of that transfer. Low relative unit labour costs combined with relatively high human capital endowment which made the region attractive to foreign investors; this induced fast technology transfer, access to high-income markets and the possibility to integrate into cross-border production networks. Some of the CESEEs (in particular, the five central European countries, CE) experienced a period of re-industrialization (i.e. fast growth in industrial production and in industrial exports) after the earlier period of de-industrialization at the beginning of transition. Furthermore, the CE economies showed evidence of significant qualitative upgrading of their industrial and export structures (see Landesmann and Stehrer, 2009 and Fabrizio, Igan and Mody, 2007) [1].

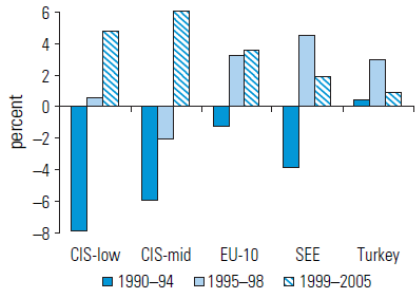
The Southeastern European (SEE) economies, on the other hand, had gone through a longer period of economic and political turbulence and hence they embarked on a process of renewed growth with a considerable time lag. They had to struggle with the long-term impact of a much more protracted period of industrial production decline (see Figure 2) which opened up a sustained gap in trade balances. This had grave implications for their vulnerability to external shocks to which we shall return below. The Baltic countries experienced phenomenal growth from the second half of the 1990s onwards, and in line with many SEE countries adopted various versions of fixed exchange rate regimes. The purpose was often to cover for the lack of trust in domestic monetary authorities and to avoid large exchange rate fluctuations that can characterise shallow foreign exchange markets. By fixing the exchange rate, these countries may have also wanted to speed-up financial and monetary integration with the eurozone. This choice of exchange rate regime played an important role in the type of imbalances which developed and contributed strongly to sustain and accentuate the problem with deteriorating trade balances.

The importance of total factor productivity (TFP) in the CESEE region

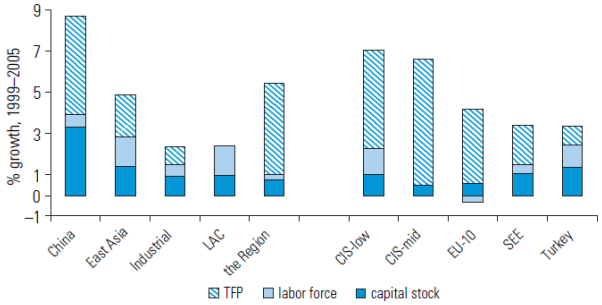
Total factor productivity (TFP) was the dominant component amongst growth determinants in CESEE before the crisis, as indicated in *Figure B1*.[2] The figure suggests that TFP growth was faster in CESEE countries in 1999-2005 than in any other region of the world, except China and CIS.[3] A crucial question is whether such high TFP growth can be expected to resume after the crisis.

Figure B1 Total factor productivity (TFP) developments

(A) Change in TFP, 1990-2005



(B) Components of growth in different regions of the world in 1999-2005



Note: CIS = Commonwealth of Independent States; LAC = Latin America and the Caribbean; SEE = South Eastern Europe; the Region = all transition countries.

Source: Figure 5A and Figure 5B from World Bank (2008), p. 11.

[1] There were also other factors at work in the successful 'growth models' of the CEs:

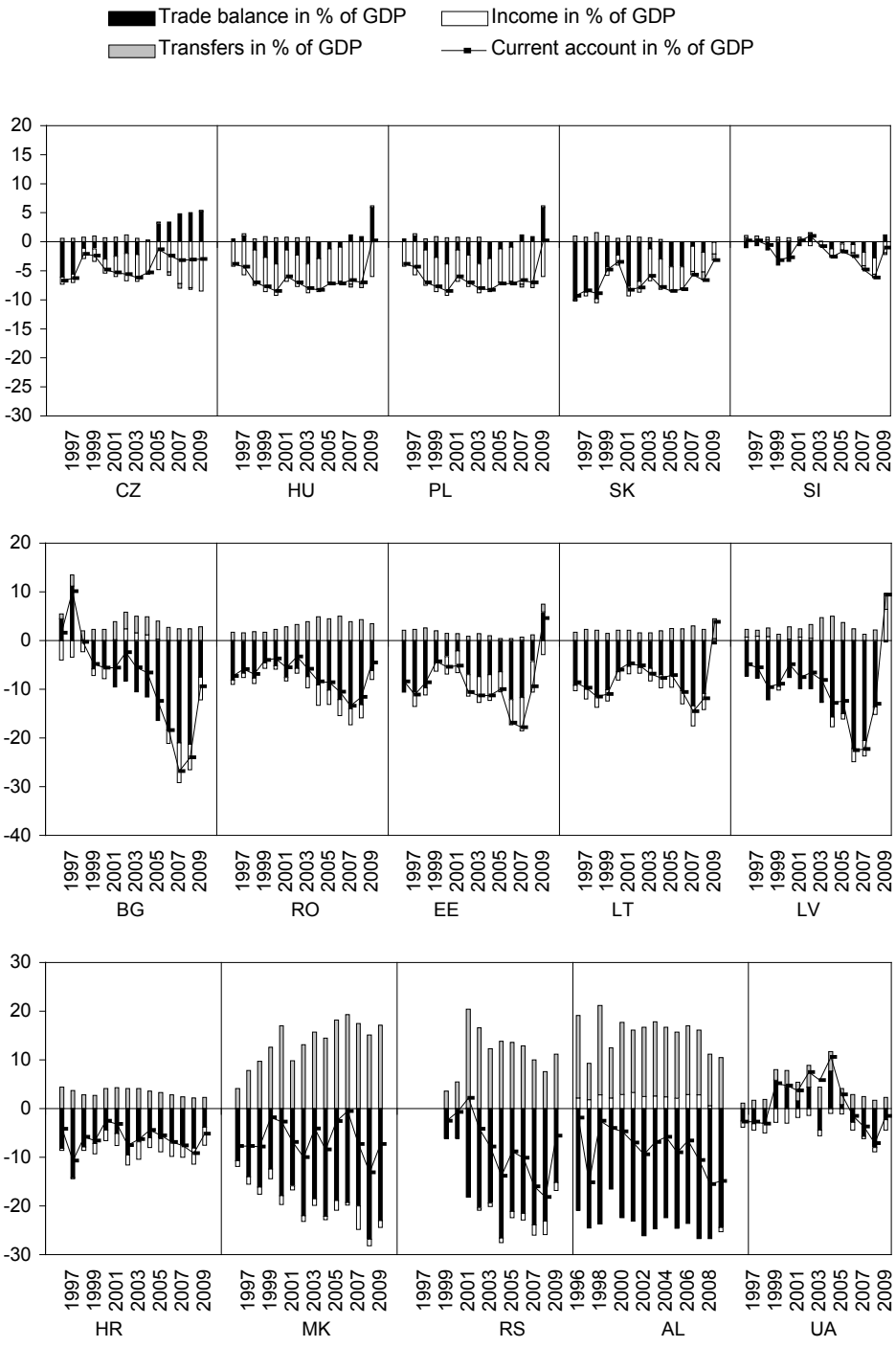
- changes in educational structures and hence the skill structure of the 'future' labour force (for this see Applica and wiiw, 2009);
- a change in sectoral and regional economic structures which meant difficult adaptation processes, but this resulted in more forward-looking patterns of sectoral and regional growth (see e.g. Roemisch, 2009).

[2] TFP is measured as the "residual" part of total output growth not explained by capital and labour. Its measurement is even shakier for CESEE and other transition countries than for advanced economies due to the lack of reliable capital stock data. Furthermore, TFP can capture cyclical movements in output as well.

[3] Iradian (2007) reaches a very similar conclusion.

Figure 3: Trade balances of goods and services and income balances, 1995-2009

in % of GDP



Note: Notice that scales vary across figures.

Source: wiiw Annual Database incorporating national statistics, Eurostat.

3. Sustainability of growth in Central and Eastern Europe – differentiation across economies

Together with a move towards a sustained high-growth and catching-up phase in the new millennium, we saw amongst CESEE economies examples of real improvements in conditions for long-run sustainability both with respect to external accounts and fiscal conditions. As regards external accounts, five Central European (CE) economies witnessed improvements in trade accounts over the past decade even in a period when these economies experienced positive growth differentials relative to their main trading partners (see Figure 3); deficits in current accounts were mostly due to negative entries in the income accounts which reflected the profits made by international investors[1]. This has been combined with qualitative up-grading in their export structures as discussed earlier. Hence, these five CE economies were on a robust path towards sustainability of external accounts and the main worry was periodic strong upward pressures on the exchange rate through strong capital inflows. In some countries, the relative movements of productivity and labour costs also impacted upon competitiveness and external accounts in specific periods.

On the other hand, as also emerges from Figure 3, there is a range of economies, especially in South-eastern Europe and in the Baltics, where the evidence did not point towards external sustainability. Trade accounts continued to deteriorate and transfers were insufficient to compensate for this; as a result these countries witnessed – before the crisis – at times dramatically worsening current accounts. These economies suffer from persistent weaknesses of their tradable sectors. The underlying issue here is the dramatic fall in industrial production in the early phase of transition from which these economies did not properly recover so far (see earlier Figure 2). Particularly problematic in this respect are over-valued exchange rates (see Holzner, 2006; Egert, 2005; Brender and Pisani, 2010) either due to exchange rate regime choices and associated monetary policies, or in some countries entrenched by a type of Dutch disease partly due to the importance of remittances, and partly based on the importance of the tourism sector, all of which hinder the development of a sufficiently sized and competitive export sector.

From this viewpoint, the crucial issue for sustainable catching-up processes in Central, Eastern and South-eastern European economies is to *support conditions for the successful development of the tradable sector* so as to achieve convergence without incurring strong current account vulnerabilities.

The conditions for an 'adapted growth model' in the light of the after-effects of the current crisis should therefore take account of the rather different situations found in the two groups of economies: (i) the relatively successful CEE economies and (ii) the economies in the Baltics and in South-eastern Europe which moved along an unsustainable path of external disequilibrium even before the crisis[2]. Both these two types of economies will have to adjust to changes brought about by the crisis, but the magnitude of the challenge is quite different. Before discussing these adjustments let us however point to further differences between the two groups of economies:

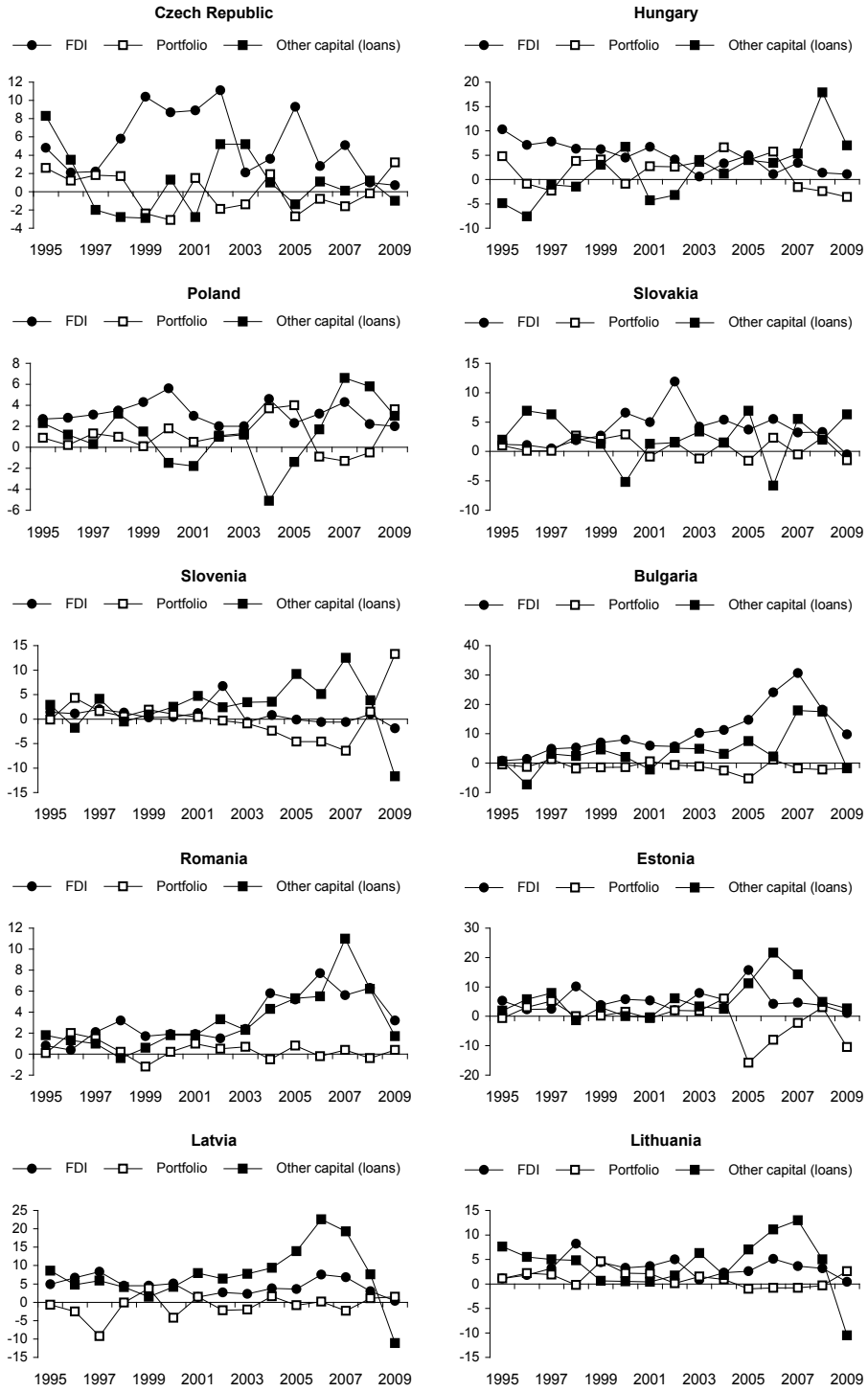
Figure 4 gives the composition of capital flows in the capital accounts. While CEE economies (with the exception of Slovenia in the most recent period) showed no signs of a strong bout of net credit inflows outstripping FDI inflows, this was a striking feature of the Baltic economies. Bulgaria and Romania experienced sharp increases in both net credit inflows and FDI inflows. Baltic and SEE economies were hence strongly vulnerable to a change in financial market risk assessment as happened in the recent crisis.

Figure 5 reveals further differences regarding the allocation of foreign direct investment across different sectors of the economy. What we see is that four of the CEE economies have a share of FDI stock in manufacturing – a sector with a high trade share – which is above or close to 40%; in most of the Baltic and Southeast European economies it is substantially below that. On the other hand, FDI shares are particularly high in a number of the SEE and Baltic economies in financial intermediation and in real estate. Hence there is a significant difference in the roles which FDI played in the different groups of economies in supporting the build-up industrial capacities and in its focus on tradable vs. non-tradable sectors. This supports the notion that the activity of foreign investors in the Baltics and the Southeast European economies contributed much less towards the build-up of a competitive and sufficiently sized tradable sector than it did in the CEs.

[1] Not only repatriated profits but also profits which are retained and reinvested by foreign firms in the host economy appear as negative entries in the income accounts.

[2] The principal issue in the CIS economies is lacking trade and production diversification and a lock-in in political-economic structures which are linked with this phenomenon; however, we shall not pursue this issue further over here (see, Landesmann, 2008).

Figure 4: Net capital flows
% of GDP, 1995-2009

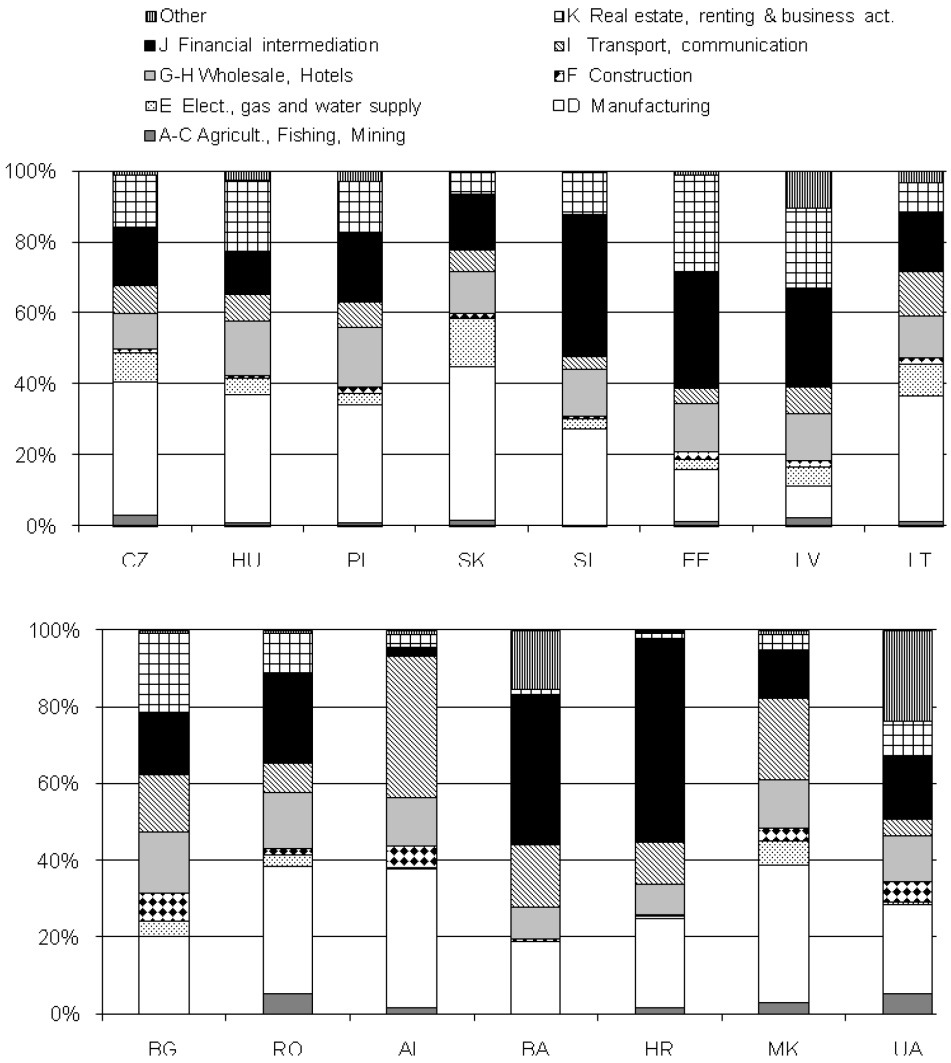


*Note: * Hungary 2008 excl. IMF loans. Notice that scales vary across figures.*

Source: wiiw Annual Database incorporating national statistics, Eurostat.

Figure 5: FDI stock by activities

as of December 2007, shares in %

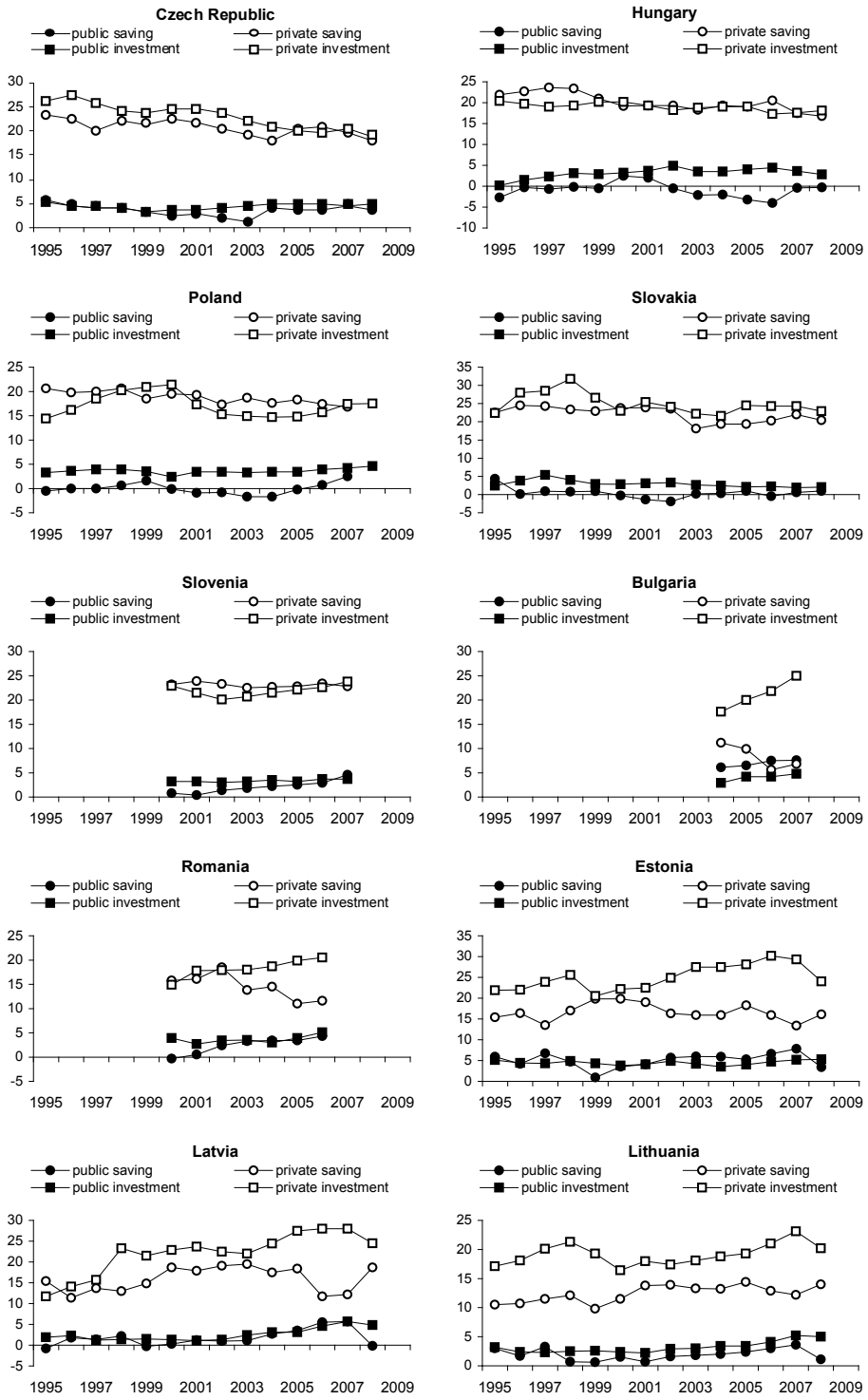


Note. Data for SK refer to 2006, data for AL refer to 2004.

Source: wiiw FDI Database.

Figure 6: Savings and investment

gross, in % of GDP



Note: Notice that scales vary across figures.

Source: wiiw Annual Database incorporating national statistics, Eurostat.

Finally, we want to point to differences in the sizes and characteristics of savings-investment gaps in the two groups of economies. As can be seen from Figure 6, these are most striking in relation to private sector savings-investment short-falls which had to be covered through foreign borrowing. Roughly the same grouping of economies emerges in this respect. Hence strong growth of net credit inflows and large savings-investment gaps of the private sector in Baltic and SEE economies before the crisis indicate a problem of effectiveness of monetary policy and capital market regulation.

In summary, the analysis indicates that it would be wrong to speak of uniform problems with the 'growth model' across the entire range of Central and Eastern European economies and hence suggestions regarding the 'redesign' of such a growth model must take such differences into account.

On the one hand, there is a group of Central European economies which are not immune to incur policy mistakes (even severe ones such as the fiscal performance of Hungary over the past decade), but these economies have mostly been on track to deal successfully with one of the very important issues which have led to the development of unsustainable imbalances before the crisis. Their performance over the period prior to the crisis has shown that they have built up a reasonably competitive trading sector which got reflected in manageable current accounts and a continued interest of foreign investors in that sector which has also had the added benefit that the composition of capital inflows reflected this interest.

On the other hand, we presented evidence for the weaknesses of the tradable sectors in all other CESEE economies. Nonetheless these economies have also been able to achieve very high growth rates in the period before the crisis, but this growth performance stood on shaky legs and cannot continue in this form following a recovery from the crisis. Future growth in CESEEs will unlikely be supported by the extent of current account deficits and the inflow of credits we have witnessed in these economies before the crisis. Most of these economies went through a serious adjustment in current account developments during the crisis which reflected sharp drops in GDP and the 'sudden stop' reaction of international financial flows. However, the crucial issue is whether there are adjustment processes at work which will allow the resumption of growth without incurring severe external imbalances in the future (for a discussion of this issue, see Darvas, 2010)[1].

[1] See, for example, the April 2010 World Economic Outlook of the IMF.

4. Redesigning the growth model in the light if changed internal and external conditions

In the following we shall discuss two sets of factors which will impact the 'growth model' in the CESEE region. We shall refer, on the one hand, to

- internal behavioural adjustments and new constraints and, on the other hand, to
- changed external circumstances

We start with the internal behavioural adjustments which are likely to prevail for a time following the recent crisis and commence with financial market developments.

The CESEE region has been the beneficiary of very large capital inflows, much higher (in relation to GDP) than was the case for other emerging market economies globally. In a sub-set of economies there was also evidence of very fast credit growth leading to substantial private sector debt. An important fall-out of the crisis was that net capital imports slowed down or came to a complete halt, credits became much more difficult to obtain, and the private sector started to embark upon a process of de-leveraging. The crisis revealed significant earlier miscalculations in risk perceptions both in relation to asset values, in the evaluation of balance-sheet positions of some of the important actors in financial markets and of default risks of households and of businesses under changed circumstances; an important element of such risks relates to exchange rates. Finally, given these changed risk perceptions, the evaluation of sovereign public sector debt also changed.

A shared evaluation of the outcome of the current crisis is that risk perceptions are not going to revert to pre-crisis levels. If risk perceptions are going to remain at a higher level over a medium-run horizon, this means that credit conditions will remain tighter than they were before the crisis; this relates to both lending behaviour within the countries but also in relation to the outside world. In addition, the crisis brought about worse balance-sheet positions of banks and of households and this also leads to more cautious lending and borrowing behaviour. Hence one of the most important outcomes of the current crisis will be that transition and catching-up economies have to adjust to *more difficult financing conditions*, both concerning finance from domestic financial institutions as well as from the outside world. Economists will, however, find it hard to predict how long higher risk perceptions are going to last.

The second likely effect of the crisis is the behaviour of the household sector itself which has and will further experience a deterioration of its own debt and/or financing position. There is considerable variation across the different CESEE economies. In some economies the levels (and/or rates of increase) of

household debt have been high or very high in the build-up to the crisis (Baltics, Romania, Croatia, Hungary) and this indeed has been one important reason for the vehemence of the transmission of the global financial crisis to this region. In three other economies (Albania, Poland and Serbia) levels of household debt might not have been that high, but depreciation of the national currencies led to a jump of household indebtedness in the cases where loans were taken out in foreign currency, though depreciation largely proved to be temporary. The implication of these financial constraints is that households have to rely more on own income sources and might be forced to reschedule loans implying higher savings rates. Other households will likely also undergo a process of voluntary de-leveraging, i.e. attempts to reduce the levels of their debt as lower expected income flows imply a lower longer-run wealth position of households. All this points to a *rise in household savings rates* in CESEE economies over the medium term.

Thirdly, *fiscal positions have and will significantly worsen* in the course of the crisis: lower incomes reduce tax revenues and the economic recession increases public expenditure commitments. Furthermore, some of the public debt is in foreign currency and hence the largely temporary depreciation of currencies affected public debt/GDP ratios. In a number of countries there was also an increase in debt to IFIs (IMF agreements). Hence although most CESEE economies (with the major exception of Hungary) went into the crisis with rather low public debt levels and governments could feel confident in a climate of high growth and relatively low interest rates that this debt could easily be serviced, the outcome of the crisis has significantly changed this perspective. While sustainability of fiscal positions did not seem a problem in a period of high growth, trend nominal appreciation of the currency and low interest rates, this scenario has now changed dramatically.

As regards fiscal policy, we want to mention two possible policy scenarios in so far as they affect medium- and long-run growth.

In principle it is possible to have both a positive or a negative outlook on fiscal policy as it affects economic growth: The positive outlook would be that the stronger fiscal constraints felt as a result of the crisis would lead to a streamlining of public expenditure programmes. This could put pressure on reforming a host of social expenditure programmes in such a way that they get more targeted and the efficiency of administrative procedures gets improved. Furthermore, governments could use the opportunity to redirect resources towards growth-enhancing spending programmes. A negative outlook would be that pressures on public spending would lead to a relative neglect of public investment in favour of defending existing government programmes rather than their reform.

To summarize: The medium-run impact of the economic crisis upon CESEE will show up in

- more difficult internal and external financing conditions
- de-leveraging processes and higher savings rates of the household sector
- a worsened public debt situation and increased pressures to reform public expenditure programmes

Let us now move on and discuss the second set of factors, namely changes in external conditions which need to be factored in when redesigning the 'growth model' of the CESEEs. The following three factors are particularly relevant in this respect:

(i) Drop in the trend growth path of the main European export markets:

The expected longer-term impact of the crisis on potential growth paths is not only relevant for the CESEE region, but also for the main export markets of the countries in this region, namely Western Europe[2] and this in turn will be a growth-dampening factor for the CESEE countries.

(ii) Reforms in the financial architecture at national, European and global levels

The experience of the crisis has shown that CESEE countries were very vulnerable to instabilities and shocks to global financial markets and, in the final analysis, these were the causes of the rather dramatic and unexpected, interruption of growth processes in CESEE economies.

Changes in the financial architecture will likely go in the direction of strengthening the capital-base of any future credit expansion, as well as empowering regulatory authorities to monitor macro-stability issues of financial (particularly banking) institutions. In all these areas, the growth processes in the CESEE region could benefit from such changes in regulation as in the past there were signs of overheated and misdirected expansion of credit (particularly when borrowing led to unsustainable bubbles) and lack of effective instruments which could be administered by domestic regulatory authorities particularly with respect to cross-border financial market transactions. Any agreements on regulatory reforms which tackle these issues of cross-border financial market integration might be beneficial for the characteristics of financial intermediation in the CESEE region.

[2] See various publication analysing the impact of the crisis on potential output: Boewer and Turini (2009), European Commission (2009), Fouceri and Mourourgane (2009).

(iii) New and differentiated positions vis-a-vis EMU membership

The experience of the crisis, particularly the fact that serious external accounts imbalances and processes of credit expansion made CESEE economies prone to contagion effects, has produced the feeling that non-Euro CESEE countries are indeed very vulnerable to financial market shocks. This had a number of contrary effects: Within the Euro-system, it strengthened the sentiment that any quick enlargement of the Euro-group would add to financial instability of the group as a whole[3]. On the other side, the events have increased the desire of some would-be-members (Baltics, some Balkan economies) to join as fast as possible to obtain the support in terms of financial and monetary stability which full Euro-membership supplies. Lastly, the differential experiences of 'fix-ex' vs. 'flex-ex' countries during the crisis have also strengthened the position of some (mostly 'flex-ex') countries that giving up their own currency too soon deprives the economy of an important instrument to absorb shocks. Hence the likelihood of earlier or later entry has become much more diverse across CESEE economies as a result of the crisis and the balance is likely to tilt towards a stricter application of rules for EMU entry.

5. Policy suggestions to support a 'reoriented' growth model

The main assets of the CESEE countries – their membership, pre-accession status or simply proximity to the EU, and all that this implies in terms of institution building and market access; as well as their relatively high human capital endowment and scope for productivity catching-up – that existed before the crisis will continue to prevail in the future and provide ground for optimism in terms of their growth prospects. On the other hand, some of the severe structural weaknesses of countries in the region have not disappeared and policy mistakes that were made in the run-up to the crisis – in the area of financial, monetary and fiscal policies – will have to be corrected in order to improve the sustainability of the growth process. Unfortunately such correction will have to take place in an environment of deteriorated external and internal conditions (see discussion in section 4 above).

Several policy suggestions emerge from the above analysis for the resumption of growth in the CESEE region and also point to the important differences relevant for different sub-groups of economies.

(i) Adjust to somewhat weaker reliance on net capital imports

Lower net capital imports (especially the net credit component) can be addressed in two ways: a) reduce the savings-investment gap of the private sector and – in due course as public finances deteriorate – through longer-run fiscal consolidation and b) make a sustained attempt to improve the current accounts though improvements in the competitiveness of the tradable sector. It is clear from our analysis that the adjustment to lower net capital imports is most severe in the economies which relied most heavily on such flows and in which the current accounts and savings-investment gaps were in serious disequilibrium. This means tackling the underlying factors which led to sustained external imbalances: in quite a few cases this means dealing with the issue of seriously 'misaligned real exchange rates' which is a particularly difficult issue to deal with in pegged or fixed exchange rate regimes without devaluation. Even under flexible exchange rate conditions, difficult phases of misaligned real exchange rates have emerged and this has to do with two issues: one are overly strong pressures on nominal exchange rate appreciations which are connected with financial market behaviour and for which better arrangements should result from financial market reforms; the other are wage-productivity dynamics which require improved arrangements for labour market bargaining systems. The issue of savings-investment imbalances is, of course, also closely linked to the difficulty of conducting monetary policy in economies with highly integrated cross-border financial markets.

Over the coming years, the CEEC region will receive increased flows from the EU budget as they either become full recipients of Structural Funds and other EU policy programmes or – in the case of other economies – the changes in pre-accession or candidate status might lead to an increase in such flows. This is a counter-weight to the more difficult situation with respect to private sector capital inflows.

(ii) Adjust to higher household savings rates but use these savings in the most growth-enhancing manner

A likely outcome of the crisis will be a medium-term increase in the household savings rates in CESEE economies. Such an increase is to be welcomed for the longer run as, in many cases, savings rates were rather low in CESEE economies by international comparison and also low savings rates were the cause of severe imbalances in a number of economies. However, an upward adjustment of household savings rates will *ceteris paribus* lead to a medium-run problem of dampened domestic demand. This can be compensated through increased fiscal stimulus and/or a drive to support the tradable sector and hence net exports. Hence the issue of adjusting to higher medium-run domestic household savings rates is linked to the discussion on the role of fiscal policy in

[3] This position was further significantly strengthened by the strains which the post-crisis developments in the IPSG countries – Ireland, Portugal, Spain and particularly Greece – generated within the euro-bloc.

CESEE in the course of the economic crisis and in its aftermath.

Furthermore, (see (iv) below), a sustained re-launch of growth in CESEE will require a more efficient use of savings than in the past. Policy instruments (credit support for SMEs, credit facilities to support skill acquisition, re-training and new technology adoption; controls on mortgage lending) could be used to make sure that savings flow in the direction that supports a sustained growth process and tackles the main weaknesses in external accounts (see also iv below).

(iii) Support the re-launch of the stalled credit system but ensure it operates with improved regulatory mechanisms.

Like in the more advanced Western economies it is vital for a sustained recovery that the credit system functions properly again. Hence there is an essential short-run challenge to reduce credit constraints to support the resumption of economic activity in an environment in which the private sector suffers from debt overhang. The expected deleveraging process in an environment in which the balance sheets of national and international banks are weak and the authority for bank restructuring is split up across national borders is a major challenge for monetary policy authorities at national and European levels. On the other hand, there is also the longer-run task to put in place improved regulatory mechanisms with regard to credit growth and also in credit allocation. Both these two issues are crucial for the prospects of recovery and the avoidance of recurrence of misallocations and imbalances which characterized the situation in quite a few economies before the crisis. Given past experience, it will in this context also be important to support a shift in banks' lending policies in the direction of more credit to the enterprise sector and less to the household sector.

(iv) Aim at the sustainability of fiscal balances, in part by redirecting public expenditure programmes in a growth-enhancing direction.

The crisis has led to serious increases in public debt positions in the CEECs although public debt levels remain significantly lower than the average in Western Europe. Nonetheless, given the more difficult financing possibilities of such debt following the crisis, attention to sustainability issues is important; this must however be weighed against the need for fiscal stimulus programmes in the shorter run to compensate for rising savings rates in the household sector and the difficult exporting conditions. Improvements in the structure of expenditure programmes and especially a redirection towards growth-enhancing items (education, infrastructure, etc.) are certainly called for.

(v) Policies directed at 'growth drivers'

Given the importance of strengthening the tradable sector in many of the CEEC economies, the whole host of policies running under the headings of human capital policy, technology policy, industrial and regional policy should be employed. They have particular relevance for economies which have so far not been able to reverse the early deep process of de-industrialization and where investment patterns favoured the expansion of non-tradable as compared to tradable sectors. Such policies may to some extent compensate for a reduced inflow of FDI which was the main agent of industrial structural up-grading before the crisis and may make the region attractive when foreign investment resumes and cross-border production integration proceeds again. The various EU regional and other policy programmes should be used in a complementary fashion to support such policies. Design of such policies and the timing of spending should be coordinated with Commission Services in such a way that they support a timely re-launch of growth and support a sustainable growth trajectory. Governance mechanisms to ensure that programmes are used efficiently need to be put into place or strengthened.

(vi) Deal with demographic aspects through labour market and educational policies but also by developing an active (human capital-enhancing) migration policy

CESEEs have – in most cases – to cope with an even worse demographic prospect in terms of ageing than most Western European countries. Policies directed at increasing the utilization of the available labour force (activity and employment rates) as well as improving its quality through human capital enhancing policies will have to be an important item on the policy agenda. On top of that, CESEEs which had for long been net-emigrant countries, will have to learn the art of successful (and human capital enhancing) migration policy.

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