Competitiveness and Convergence in CEE: What Can We Learn From 20 Years of EU Membership?

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The 20th anniversary of the accession to the European Union (EU) in many countries in Central and Eastern Europe (CEE) is the perfect occasion to take an in-depth look at the economic development of all new member states and the convergence towards the biggest EU economies. New member states from CEE have come a long way in the last two decades, building upon their competitive advantages, expanding economic freedom and seizing the opportunities of the European Single Market.

The economies in the CEE region may be relatively small in comparison to the biggest EU economies, but their economic growth is consistently stronger, and they are catching up. The share of the ten new member states from the CEE region[1], which are examined in this article, in the total EU economy (in terms of GDP) increased from 6.2% in 2004 to 11.2% in 2022[2]. These are most of the countries from the EU's 'fifth' enlargement in 2004 (the Czech Republic, Poland, Hungary, Estonia, Latvia, Lithuania, Slovakia, and Slovenia) and the two countries from the EU's 'sixth' enlargement in 2007 (Bulgaria and Romania). All of these countries have integrated deeper within the wider EU economy and converged significantly towards the EU's biggest economies[3].

> THE ECONOMIES IN THE CEE REGION MAY BE RELATIVELY SMALL IN COMPARISON TO THE BIGGEST EU ECONOMIES, BUT THEIR ECONOMIC GROWTH IS CONSISTENTLY STRONGER, AND THEY ARE CATCHING UP

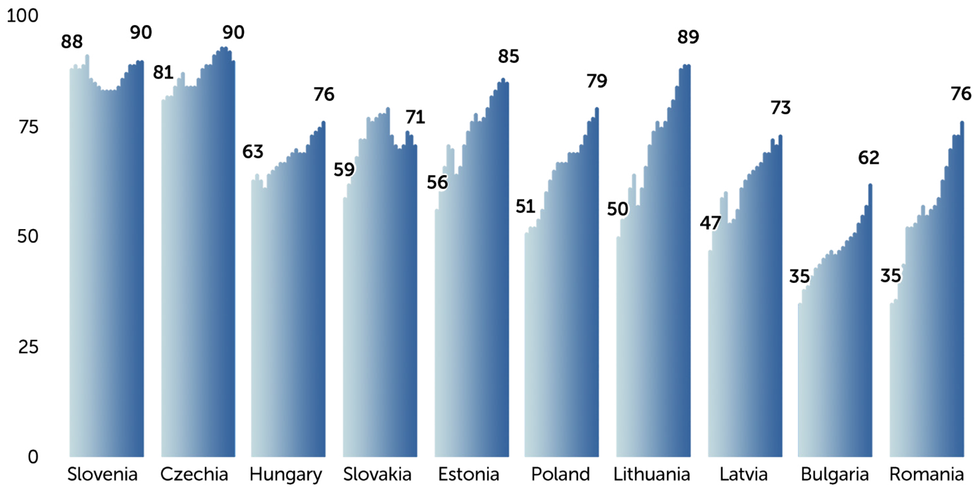
The catching-up process has been accompanied by many challenges, with the EU economy going through at least three major crises in the last 20 years – the financial crisis of 2008-2009 (referred to as the 'Great Recession'), the mild recession of 2012-2013 (following the European debt crisis), and the sharp decrease in economic activity during the COVID-19 pandemic (2020). These episodes of economic downturn affected the new member states, but they still managed to return to the path of convergence rather quickly. At the end of 2023, following the energy crisis and the highest inflation in both new and old member states in the last 20 years, the EU

[1] This article focuses on ten new member states from the CEE region: The Czech Republic, Poland, Hungary, Estonia, Latvia, Lithuania, Slovakia, and Slovenia from the EU's 'fifth' enlargement in 2004 (Cyprus and Malta are not included) and Bulgaria and Romania from the EU's 'sixth' enlargement in 2007.

[2] Eurostat (2024) *Gross Domestic Product at Market Prices*. Available [online]: https://ec.europa.eu/eurostat/databrowser/view/nama_10_gdp__custom_9936356/default/table

[3] The five biggest economies in the EU are Germany, France, Italy, Spain, and the Netherlands. These five countries represent 2/3 of the total EU economy (in terms of GDP). In this article, when investigating the performance of CEE countries, they are compared either to the EU average level (EU 27) or, in some cases, in relation to the performance of the five biggest economies in the EU.

Figure 1: GDP per capita in purchasing power parities (EU27=100, 2004-2022)



Source: Eurostat[4]

is once again heading into a recession[5], making the topic of competitiveness, economic growth, and convergence highly relevant. In addition, some CEE countries are experiencing recent periods of political instability[6], which may potentially undermine their economies.

The main thesis of the article is that the competitiveness of the new member states is key to faster growth and convergence. Countries implementing policies to support their competitiveness – expanding economic freedom and removing barriers, strengthening institutions and the rule of law, easing business environment, and staying fiscally responsible, ultimately perform better within the Single Market

SOME CEE COUNTRIES ARE EXPERIENCING RECENT PERIODS OF POLITICAL INSTABILITY, WHICH MAY POTENTIALLY UNDERMINE THEIR ECONOMIES

[4] Eurostat (2024) Volume Indices of Real Expenditure Per Capita (in PPS_EU27_2020=100). Available [online]: https://ec.europa.eu/eurostat/databrowser/view/prc_ppp_ind__custom_9461210/default/table

[5] Eurostat (2024) *GDP Main Aggregates for the Fourth Quarter of 2023*. Available [online]: https://ec.europa.eu/eurostat/en/web/products-euro-indicators/w/2-08032024-ap

[6] An obvious example in this respect is Bulgaria, which held five parliamentary elections between 2021 and 2023.

[7] Ibid.

> IN
> THE EVER-CHANGING AND HIGHLY UNPREDICTABLE WORLD, NEW EU MEMBER STATES NEED TO PRESERVE THEIR COMPETITIVE ADVANTAGES AND PURSUE POLICIES
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and grow faster. In the ever-changing and highly unpredictable world, new EU member states need to preserve their competitive advantages and pursue policies that provoke private investments, attract talent, and, ultimately, lead to economic growth.

THE PATH TO CONVERGENCE

The most straight-forward indicator to analyze the convergence within the European Union (EU) is the gross domestic product (GDP) per capita expressed in purchasing power standards (PPS) and, more specifically, the deviation from the EU average for the individual countries. Back in 2004, most of the new member states from Central and Eastern Europe (CEE) were at around 50-60% of the EU average[8]. This means that the real expenditures of their citizens (also considering the price differences) were almost twice as low than the EU average. Six out of the eight new member states from CEE in 2004 were in the 47-63% range, and only the Czech Republic and Slovenia were above 80%. In the same period, just three years before their accession in 2007, Bulgaria and Romania were at 35% from the EU average.

Nearly 20 years later, four of the new member states from CEE are at 85-90% and the other four within 70-80% of the EU average[9]. Bulgaria and Romania also recorded significant growth reaching 62% and 76% of the EU average, respectively. Romania is, in fact, already catching up with the other CEE countries, with only Bulgaria remaining below the 70% mark [See: Figure 1]. It is evident that in the last two decades the whole CEE region converged significantly with the EU's biggest economies and, although not entirely, this is undoubtedly linked to the participation in the EU Single Market and the deeper integration with the wealthier Western economies.

This period of convergence for the new member states is not necessarily a period of convergence across the entire EU. On the contrary, over the last 20 years, convergence indicators in the old member states have not shown much improvement, which is a direct result of rather slow

[8] Eurostat (2024) *Volume Indices of Real Expenditure Per Capita (in PPS_EU27_2020=100)*. Available [online]: https://ec.europa.eu/eurostat/databrowser/view/prc_ppp_ind__custom_9461210/default/table

[9] Ibid.

> IT IS EVIDENT THAT IN THE LAST TWO DECADES THE WHOLE CEE REGION CONVERGED SIGNIFICANTLY WITH THE EU'S BIGGEST ECONOMIES AND, ALTHOUGH NOT ENTIRELY, THIS IS UNDOUBTEDLY LINKED TO THE PARTICIPATION IN THE EU SINGLE MARKET AND THE DEEPER INTEGRATION WITH THE WEALTHIER WESTERN ECONOMIES

economic growth and the debt burden over the biggest economies in the EU. In the last two decades, convergence indicators for countries like Italy, France, and Spain have deteriorated, falling below the EU average threshold (France is right on the borderline, but with a negative trend), while Germany and other Nordic economies, manage to keep the debt burden under control and remain well above the EU average in terms of GDP per capita in purchasing power parities[10].

This observation shows that the countries that have benefited the most from the single market in the last 20 years are precisely the new member states from CEE. Their competitive advantages related to lower costs and better environment for doing business, prudent fiscal policy, and much lower burden of government debt, allowed them to benefit greatly from the access to the wide EU market. In that respect, the single market does not guarantee convergence, but it allows countries to exploit their competitive advantages, integrate deeper with the biggest economies in Europe and pursue policies to support economic growth. The process of catching-up was also facilitated by the expansion of economic freedom in CEE region in the last two decades.

ECONOMIC FREEDOM IS KEY FOR THE CEE REGION

The expansion of economic freedom is a crucial factor for the success of the new member states in the EU. In the early 1990s, most of the countries in Central and Eastern Europe were among the least free economies in the world, as presented by the Economic Freedom of the World annual reports, published by the Fraser Institute[11]. The index measures the degree to which the policies and institutions of countries are supportive of economic freedom,

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[10] Eurostat (2024) *Volume Indices of Real Expenditure Per Capita (in PPS_EU27_2020=100).* Available [online]: https://ec.europa.eu/eurostat/databrowser/view/prc_ppp_ind__custom_9461210/default/table

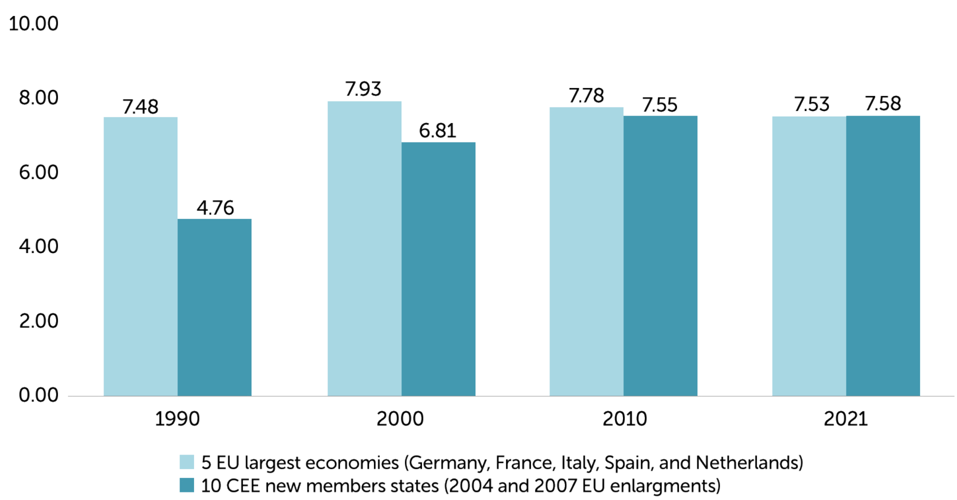
[11] Fraser Institute (2023) *Economic Freedom of the World: 2023 Annual Report.* Available [online]: https://www.fraserinstitute.org/sites/default/files/economic-freedom-of-the-world-2023.pdf

covering five broad areas – the size of government, legal system and property rights, sound money, freedom to trade internationally, and regulations. By the year 2000, the entire CEE region had improved significantly in their economic freedom score, while still underperforming (especially Bulgaria and Romania) in comparison to the biggest economies in the EU (Germany, France, Italy, Spain, and Netherlands).

Over the next 20 years the CEE countries continued to expand their economic freedom, joining the EU (2004 and 2007) and taking advantage of the vast opportunities of the EU Single Market [See: Figure 2]. In the years since their accession to the EU, the new member states have been catching up in economic freedom with their Western counterparts, with the average score of the ten new member states slightly outpacing the average score of the five largest economies in the EU in the latest report (2023). This process has been driven by removing barriers and easing regulations as part of the EU Single Market – meaning free movement of people, services, goods, and capital, as well as preserving a competitive tax policy and rather prudent fiscal policy.

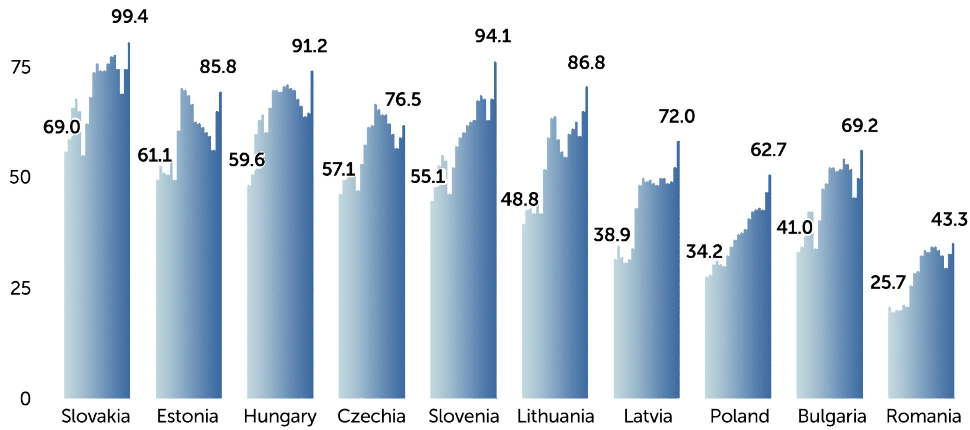
> THE COUNTRIES THAT HAVE BENEFITED THE MOST FROM THE SINGLE MARKET IN THE LAST 20 YEARS ARE PRECISELY THE NEW MEMBER STATES FROM CEE

Figure 2: Economic freedom score by Fraser Institute (1990-2021)



Source: Own calculations based on: Fraser Institute (2023) Economic Freedom of the World: 2023 Annual Report

Figure 3: Exports of goods and services in CEE (% of GDP, 2004-2022)



Source: Own calculations based on: Fraser Institute (2023) Economic Freedom of the World: 2023 Annual Report

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THE EXPANSION OF ECONOMIC FREEDOM IS A CRUCIAL FACTOR FOR THE SUCCESS OF THE NEW MEMBER STATES IN THE EU

At present, quite a few of the new member states from the CEE region and the Baltics are among the freest economies in the world, although there is no representative in the top 10. The highest freedom score of the new member states is in Estonia (7.95), Lithuania (7.95), and the Czech Republic (7.81), while the lowest is in Poland (7.12), Slovenia (7.23), and Hungary (7.36). A crucial factor for the better performance within the CEE region seems to be the legal system and the rule of law.

The expansion of economic freedom in the CEE region is clearly visible in the first years of EU membership, but in the last decade there has been a stagnation of the freedom score – against the background of a slight retreat of economic freedom in the largest EU economies. The stagnation of economic freedom in the CEE region has been triggered by the growth of government spending and the size of government, in some cases increased regulatory burden, and a lack of sufficient progress in the area of the rule of law. Bulgaria is a notorious example in this field, receiving high scores in various economic areas – sound money, freedom to trade, and taxation, while failing to catch

[12] Eurostat (2024) Exports of Goods and Services (% of GDP). Available [online]: https://ec.europa.eu/eurostat/databrowser/view/nama_10_gdp__custom_9937450/default/table

AT PRESENT, QUITE A FEW OF THE NEW MEMBER STATES FROM THE CEE REGION AND THE BALTICS ARE AMONG THE FREEST ECONOMIES IN THE WORLD

up in terms of the legal system, judicial independence, and, in essence, corruption.

CELEBRATING THE SINGLE MARKET

Being part of the EU Single Market allowed the new member states to increase the openness of their economies and deepen their integration within the EU supply chains. Exports increased considerably in all new member states – not only in absolute terms, but also as a percentage of the economy. Back in 2004, exports of goods and services in all new member states did not exceed 70% of GDP, and, in some cases, were even below 50% of GDP[13]. In the following two decades, there has been a steady increase in the share of exports in the entire CEE region, with the share of exports in most of the countries under consideration rising by more than 25 percentage points and, in some cases, the total exports of goods and services reached over 90% of GDP [See: Figure 3].

Over the last 20 years, there has also been an increase in exports in the old member states, with exports in the euro area rising from 35% of GDP in 2004 to over 50% of GDP in 2022. This development reflects the opportunities of the single market and the deeper integration of the supply chains in the EU. Intra-EU trade has grown significantly over the last two decades, with the the total volume of intra-EU exports increasing from EUR 1.7 trillion in 2004 to EUR 4.3 trillion in 2022[14]. The share of intra-EU exports of the ten new member states increased from EUR 180 billion in 2004 (11% from the EU total) to EUR 840 billion in 2022 (20% from the EU total). In other words, the new member states doubled their share in internal exports of goods within the EU.

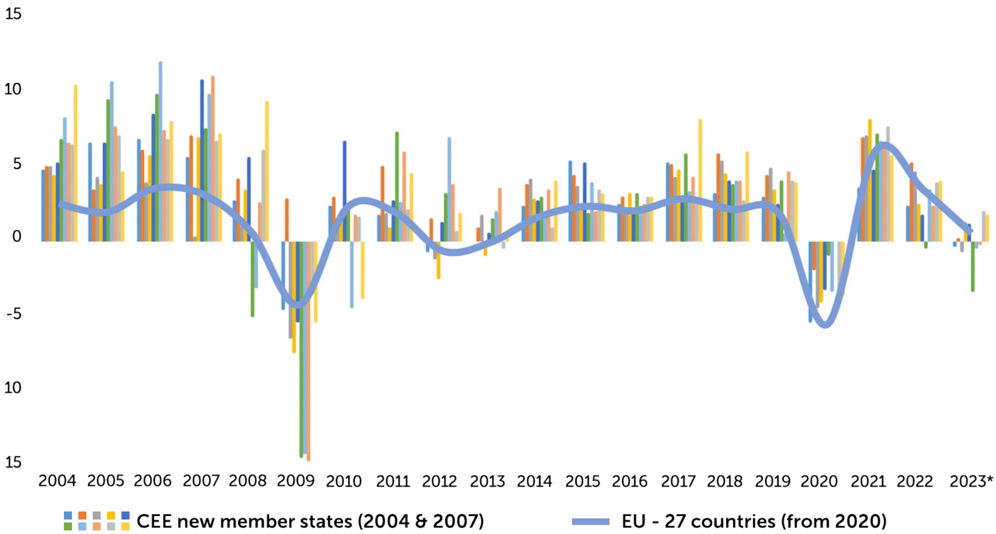
The single market means not only trade in goods and services, but also free movement of people and capital in the EU. The new member states have benefited greatly from the influx of foreign capital, especially in the early years of EU membership. The total stock of foreign direct capital from the EU in the ten new member states from the CEE region reached above EU 750 billion in 2022[15], which has contributed to the economic growth in the region. Foreign direct investments in Bulgaria almost doubled in the last 20 years, with as much as 75% of the foreign capital coming from the EU countries. However, one may argue that the foreign capital contribution to growth in the CEE region is conditional upon implementing economic reforms that support competitiveness and investment in human capital.

[13] Ibid.

[14] Eurostat (2024) *Intra-EU Trade in Goods (Exports in EUR Million).* Available [online]: https://ec.europa.eu/eurostat/databrowser/view/ext_lt_intratrd__custom_9971224/default/table

[15] Eurostat (2024) *EU Direct Investment Positions, by Countries.* Available [online]: https://ec.europa.eu/eurostat/databrowser/view/bop_fdi6_geo__custom_10308540/default/table

Figure 4: GDP growth in CEE and EU-27 (%, 2004-2023)



Source: Eurostat*[16]

*Data for 2023 is based on: European Commission (2024) European Economic Forecast

BEING PART OF THE EU SINGLE MARKET ALLOWED THE NEW MEMBER STATES TO INCREASE THE OPENNESS OF THEIR ECONOMIES AND DEEPEN THEIR INTEGRATION WITHIN THE EU SUPPLY CHAINS

TWO DECADES AND THREE EPISODES OF ECONOMIC DOWNTURN

There is no doubt that the economies of the CEE region had experienced economic growth in the last two decades and were catching-up with the biggest economies in the European Union. CEE countries registered higher economic growth than the EU average in most of the last 20 years. While this may be viewed as a rather long period of, predominantly, economic growth, there were also turbulent times that challenged the EU economy. There were three clear episodes of economic downturn in the European Union in the last two decades, which also affected the new member states [See: Figure 4].

[16] Eurostat (2024) *GDP at Market Prices (Chain Linked Volumes, Percentage Change on Previous Period)*. Available [online]: https://ec.europa.eu/eurostat/databrowser/view/nama_10_gdp__custom_9994154/default/table

The first period was the global financial crisis (referred to as the 'Great Recession'), which plunged Europe into a prolonged recession in late 2008 and throughout 2009. Almost all of the CEE new member states (except Poland) went into a severe recession – the Baltic countries registered a drop in GDP of 14-15% in 2009 alone[17]. Although full recovery from the crisis took years across Europe, CEE countries managed to return to economic growth and convergence rather quickly.

The second period, directly related to the aftermath of the global financial crisis, is the European debt crisis, which pushed Europe into a shallow recession in 2012 and 2013. In this episode, some of the CEE countries experienced a period of low growth, other went into a short recession, but overall, the new member states performed better than the biggest economies in the EU[18]. The economies in the CEE region were better prepared for this economic period, which is related to the lower levels of public debt and better fiscal performance in the new member states[19].

The third period of economic downturn came with the COVID-19 pandemic that plunged Europe into a deep, but rather brief, recession in 2020[20]. The pandemic disrupted the supply chains throughout the world and, in a way, revealed the importance of the single market in Europe – when free movement of goods and people is disrupted, the economy collapses. However, recovery has been swift, and the CEE countries performed well, registering strong growth in 2021, and returning relatively quickly to the pre-pandemic levels of economic activity. While the global financial crisis had lasting effects on the labor market and unemployment, jobs were quickly recovered after the initial shock of the pandemic, and employment levels had been at record high levels both in the CEE region and the entire EU[21].

> THE NEW MEMBER STATES DOUBLED THEIR SHARE IN INTERNAL EXPORTS OF GOODS WITHIN THE EU

Nevertheless, turbulence was far from over. In February 2022, Russia invaded Ukraine in a horrific act of violence. Supply chains in Europe were once again disrupted and energy prices exploded. Inflation reached record-high levels in both new and old member states in late 2022[22], and the European

[17] Eurostat (2024) *GDP at Market Prices (Chain Linked Volumes, Percentage Change on Previous Period)*. Available [online]: https://ec.europa.eu/eurostat/databrowser/view/nama_10_gdp__custom_9994154/default/table

[18] Ibid.

[19] Eurostat (2024) *Government Consolidated Gross Debt*. Available [online]: https://ec.europa.eu/eurostat/databrowser/view/gov_10dd_edpt1__custom_9940787/default/table

[20] Eurostat (2024) *GDP at Market Prices (Chain Linked Volumes, Percentage Change on Previous Period)*. Available [online]: https://ec.europa.eu/eurostat/databrowser/view/nama_10_gdp__custom_9994154/default/table

[21] Eurostat (2024) *Total Employment (Percentage of Population)*. Available [online]: https://ec.europa.eu/eurostat/databrowser/view/lfsi_emp_a__custom_10304605/default/table

[22] Eurostat (2022) *Annual Inflation Up to 10.6% in the Euro Area (October 2022)*. Available [online]: https://ec.europa.eu/eurostat/documents/2995521/15265521/2-17112022-AP-EN.pdf

> THE NEW MEMBER STATES HAVE BENEFITED GREATLY FROM THE INFLUX OF FOREIGN CAPITAL, ESPECIALLY IN THE EARLY YEARS OF EU MEMBERSHIP

Central Bank (ECB) raised interest rates in ten consecutive steps (from July 2022 to September 2023)[23]. As a result, inflation went down and is currently under control[24], but, by the end of 2023, economic growth in Europe disappeared, and the European Union is on the verge of a fourth episode of economic decline in the last 20 years.

By the end of 2023, the entire CEE region is experiencing a slowdown in growth, with at least five countries registering negative economic growth – the Czech Republic, Hungary, and the Baltic countries. Although the latest forecast of the European Commission[25] shows that the EU economy as a whole may avoid entering into recession and the expectation is for the return of the economic growth in CEE region in 2024, the events from recent years clearly show that the new member states should stay resilient to shocks and improve competitiveness. In a turbulent environment, with various political and geopolitical risks in the region, policies in support of economic growth and the rule of law are crucial for moving forward.

THE BURDEN OF PUBLIC DEBT

One of the main differences between the CEE countries and the largest economies in Europe are the debt burden and the sustainability of public finances. All of the new member states are below the EU average in terms of government spending. While government spending in the European Union on average reaches 50% of GDP (2022), eight out of ten new member states from the CEE region register government spending below 45%, with the three Baltic countries (Estonia, Latvia, and Lithuania), Bulgaria, and Romania being below or close to 40% of GDP[26]. This is a 10-percentage point difference than the levels in Germany, and 15-percentage point difference in comparison to France and Italy. The highest share of government spending in CEE region in 2022 is in Slovenia (47% of GDP) and Hungary (49% of GDP).

Most CEE countries had public debt levels below 30% of GDP in the year of their EU accession[27]. Public debt in the new member states increased during the global financial crisis and the European debt crisis, and then again during the pandemic, but

[23] ECB (2024) *Key ECB Interest rates*. Available [online]: https://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html

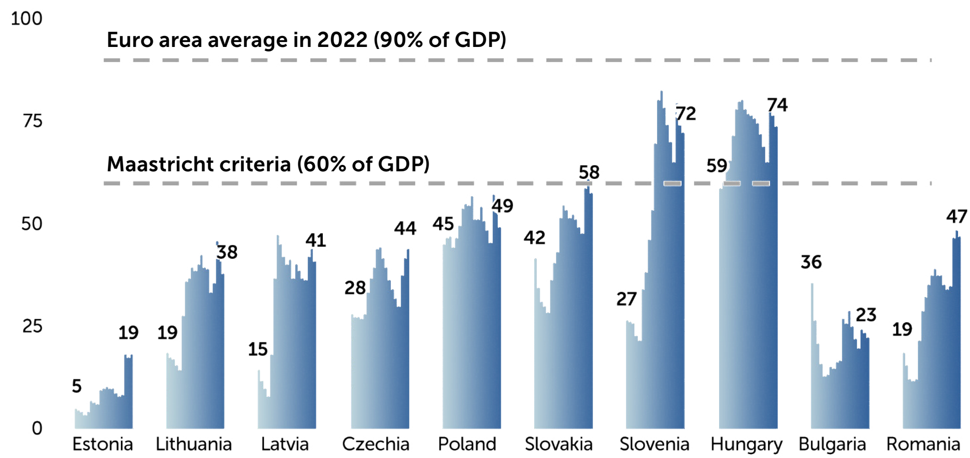
[24] Eurostat (2022) *Annual Inflation Down to 2.8% in the Euro Area (January 2024)*. Available [online]: https://ec.europa.eu/eurostat/en/web/products-euro-indicators/w/2-22022024-ap

[25] European Commission (2024) European Economic Forecast. Available [online]: https://ec.europa.eu/commission/presscorner/detail/en/ip_24_730

[26] Eurostat (2024) *Total General Government Expenditure*. Available [online]: https://ec.europa.eu/eurostat/databrowser/view/gov_10a_main__custom_9939353/default/table

[27] Eurostat (2024) *Government Consolidated Gross Debt*. Available [online]: https://ec.europa.eu/eurostat/databrowser/view/gov_10dd_edpt1__custom_9940787/default/table

Figure 5: Government consolidated gross debt in CEE and EU-27 (%, 2004-2022)



Source: Eurostat[28]

still remained at sustainable levels – only two countries (Slovenia and Hungary) went beyond the 60% of GDP limit [See: Figure 5]. Estonia and Bulgaria are the best performers here, keeping their debt to GDP ratio at around 20-25% even after the pandemic. At the same time, debt levels in the euro area reach over 90% in 2022, with Italy, France, Spain, and Portugal being above 100% of GDP.

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THE EVENTS FROM RECENT YEARS CLEARLY SHOW THAT THE NEW MEMBER STATES SHOULD STAY RESILIENT TO SHOCKS AND IMPROVE COMPETITIVENESS

Despite the lower public debt levels in the CEE region, it should be noted that while 20 years ago all the new member states from CEE had low public debt, in 2022, the picture is different and only Estonia and Bulgaria retain very low public debt levels. A series of episodes of economic downturn, including the financial crisis and the pandemic, triggered larger deficits across Europe and eventually led to higher debt in CEE countries. Large economies, such as Germany and the Netherlands already stand comparable in public debt levels to some CEE countries. Germany currently has a lower debt level than Slovenia and Hungary, and the Netherlands is performing even better, having a comparable public

[28] Ibid.

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CEE NEW MEMBER STATES HAVE COME A LONG WAY IN THE LAST 20 YEARS

debt level to countries like Slovakia, Poland, and Romania. Rising government spending and public debt levels in the CEE region are among the factors that could undermine competitiveness in the new member states and limit growth in the long-term.

THE NEXT 10 YEARS

CEE new member states have come a long way in the last 20 years. Economic freedom in the entire region expanded and CEE countries converged significantly with the rest of the EU. Participation in the Single Market has allowed the new member states to exploit their competitive advantages, integrate into European supply chains, and double their share of intra-EU trade. Looking at the economic growth in the region and the convergence indicators, we may argue that the countries that have benefited the most from the single market in the last 20 years are precisely the new member states from CEE.

In this period, Europe has gone through at least three severe economic crises that have affected CEE economies but have not reversed the general trend of convergence. At the end of 2023, the EU is once again close to recession, making the topic of competitiveness, economic growth, and convergence in the CEE region highly relevant. Series of crises and episodes of economic downturn had shown that maintaining macroeconomic stability and resilience, as well as implementing far-reaching economic reforms to support competitiveness are key to the success of the new member states.

Major challenges on the eve of the third decade of EU membership are related to the turbulent geopolitical situation and the big unknown of the outcome of Russia's aggression in Ukraine, the political instability in some CEE countries, lack of sufficient progress in terms of the rule of law and corruption, elements of state capture, and democratic backsliding in the region. Against the backdrop of these mainly political risks, economic policies in individual member states and at the EU level are key for the future of the region. CEE should aim to remain the fastest growing part of Europe in the next decade.

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