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NEWS OF THE MONTH

on EU-10 and CIS



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The ICEG European Center issues its monthly publication, which includes 2-4 brief analyses on macroeconomic and microeconomic issues. The publication focuses on two groups of countries: **Commonwealth of Independent States - CIS** (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) and the ten post-soviet New Member States of the European Union – **EU-10** (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia).

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About us

ICEG European Center is an independent economic research institute based in Budapest, Hungary. The Center was founded by Dr. Pál Gáspár in 2001.

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Every innovation has its inherent “malady”

Olivér Kovács

In early 2013, United Nations, one of the most considerable institutional bearers of the torch of sustainable development, published its recent paper called “The Future We Want”¹ in which all of the participants at the United Nations Conference on Sustainable Development in Rio de Janeiro took place on 20-22 June 2012 reaffirmed *inter alia* that democracy, good governance and the rule of law, at the national and international levels, as well as an enabling environment, are essential for sustainable development, including sustained and inclusive economic growth, social development, environmental protection and the eradication of poverty and hunger.

The overarching and benevolent goals are establishing a solid claim for more intensified and efficient international cooperations among various actors (e.g. governments, scientific community, civic groups etc.) in coping with grand challenges successfully. To a certain extent, it also reflects that mankind has started to acknowledge that old issues require new solutions in the constantly evolving web of interactions in our highly globalised world.

To this end, fostering all types of innovation (i.e. product and services innovation, process-, marketing-, and organisational novelties) both in the private and public sectors (Kovács, 2011; 2012) are of paramount importance in nurturing resilience necessary to our complex socio-economic system facing constant changes and challenges (e.g. depletion of natural resources, climate change, demographic challenges etc.).

Notwithstanding the consensual view stating that innovation can be seen as the last resort of humanity by which the sustainable development can become a real perspective; innovation has always its unintended consequences to be reckoned with.

In the CIS countries the so-called natural resource curse can still be found and documented (Ahrend 2005; Dobrynskaya – Turkisch, 2010; Kronenberg, 2004; Treisman, 2010). Apart from the fact that the primary reliance on natural resources (Russia, Kazakhstan, Azerbaijan, Turkmenistan) often has a negative impetus on the socio-economic development of the given country, extracting as well as selling natural gas and oil is undisputedly hampering the global transformation into a low-carbon paradigm.

¹ United Nations (2013): The Future We Want. RIO-20 Outcome Document. Available: <http://sustainabledevelopment.un.org/content/documents/733FutureWeWant.pdf> Accessed on: 25.02.2013

At this point, the role of innovation is heavily appreciating in directing the development toward less and less carbon-dependent economic structures. Albeit, thinking about innovation as a key engine of long term economic growth and prosperity is now going to platitude; no one should live under the delusion that innovations have only positive side, they can easily have (if not always have) relevant negative consequences (i.e. costs) to be addressed.

In case of natural gas and oil extraction, innovation may also play an essential role but presumably not without having negative repercussions simply because we are dealing with scarcity. As Wilhelm Röpke once emphasised, we cannot fill a hole without opening another one necessarily somewhere else (Röpke, 1963:12).

Innovation in fields like natural resources

Innovation in fields like natural resource extraction often aims at increasing the productivity by exploring and using unconventional sources. Increasing productivity is associated with lowering market prices² which in turn direct towards more demand in natural (non-renewable) energy resources. In recent years, the widespread diffusion of the so-called hydraulic fracturing complemented with horizontal drilling has proved to be quite conducive to productivity of natural gas wells. The term hydraulic fracturing refers to the process of injecting fluid (i.e. a mix of water, sand and other chemicals) into the wells and the high pressure is able to create cracks and fissures that improve the natural gas production of these wells. Consequently, this technique requires the usage of water resources in a more intensive way.³

This fact calls for continuous innovation because innovation in one field can establish a solid claim for innovation in another field to meet the requirement of humanity for sustainable development (i.e. the harmony among economic, social and environmental dimensions).

Continuous innovation in more complex systems and implications for governance

By now, the world is more complex than ever before due to the ruling role of interdependency well-known from development economics, and *inter alia* the faster velocity embedded into our even more complex socio-economic texture triggered primarily by technological development (i.e. Internet, ICT based techno-economic paradigm resulted in the abundance of information by leading to the era of

² Due to the usage of the new technique, the market price of natural gas has slumped by 75% in four years in the United States by lowering the global prices as well leading to threats over the sustainability of the current level of Russian oil-revenues and that of other petro-countries.

³ In a comprehensive study, Cooley and Donnelly (2012) looked at the issue of how hydraulic fracturing is associated with concerns over water resources and found that the key water-related concerns identified by the interviewees included (i) water withdrawals; (ii) groundwater contamination associated with well drilling and production; (iii) wastewater management; (iv) truck traffic and its impacts on water quality; (v) surface spills and leaks; and (vi) stormwater management.

'immediacy'. With the increasing complexity of our systems, academic scholars and policymakers should be aware of the fact that complex issues require, by very nature, complex solutions.

This would *per se* imply that each governance have the capacity for implementing complex solutions. In the real world, we have not got by any means omnipotent governance that could conduct the perfect strategy by shaping our world towards the desired outcome.

It holds if for no other reason than because as complexity grows, public sector actors are facing more vigorously the constraints in understanding adequately the complex system and in identifying concrete and isolated problems. Due to the web of causal links and the cascading effects of each intervention (i.e. non-linearity), one intervention can trigger a series of changes without knowing preliminarily what will be the real end result of that.⁴ It has significant implication for the contemporary concept of governance.

As a corollary, the notion of governance has to be reconsidered by accepting that we should be prepared for constant social learning by resorting to trial-and-error methods. As a corollary, governance should consider next practices in its economic policy engineering rather than pursuing some kind of best practices applicable without doubts across time and space. The main message decipherable is that public sector innovation should be continuous and always be directed towards a resilient governance and public sector being able to bear the burden determined by the permanent learning through trial-and-errors.

To sum up, while innovation is rightly regarded as the wellspring of change towards something better, assessing its effectivity and efficiency always needs a more broader context since every innovation has its own costs to be tackled, in other words: there are no final solutions, because one may solve a particular problem but might trigger a new one somewhere else.

⁴ Let think of the current crisis-management when governments in advanced world were about to maintain aggregate demand by avoiding the recessionary effect of the financial meltdown. However, the applied monetary and fiscal stimuli (e.g. fiscal stimuli accounted to 787 billion dollar only in the United States) did not prove to be a viable option, because it has just delayed the inevitable. The fiscal austerity – which came imperatively after the stimuli – had also negative effect on growth because of the chronic underestimation of the value of fiscal multiplier coupled with the systemic overestimation of the expected GDP path. The so-called non-linearity played a crucial role in this type of development: fiscal stimuli has multiple effects that cannot be calculated previously and inbuilt into the econometric models accurately (e.g. fiscal consolidation related literature postulates that fiscal stimuli and austerity affects the expectations of citizens over future income: when austerity is coming, people expect significant decrease in future taxation and thus they become more willing to spend in the present by maintaining demand. Nonetheless, they appear to take their consumption decisions on the basis of current income, however).

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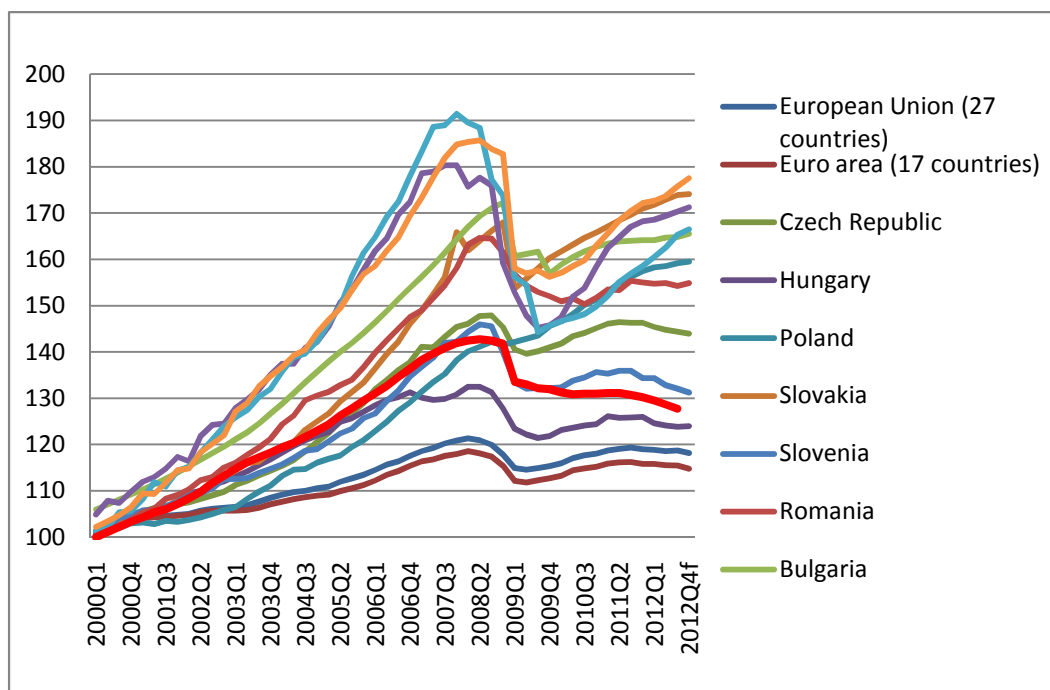
Croatia: EU accession with recession, speculative grades and fiscal problems

Péter Sulán

Croatian long term ratings have recently been downgraded both by Moody's (to Ba1 on 1st February 2013) and S&P (to BB+ on 14th December 2012) with stable outlook. Fitch confirmed its BBB- rating for foreign currency denominated debt and BBB for domestic currency debt on 29th November 2012 with negative outlook. It most probably means that on 1st July 2013 Croatia will join the European Union with speculative grades.

The country's economic situation is rather disappointing. After the decline in 2008-2009, GDP bounced back in almost all countries in Europe except Croatia.

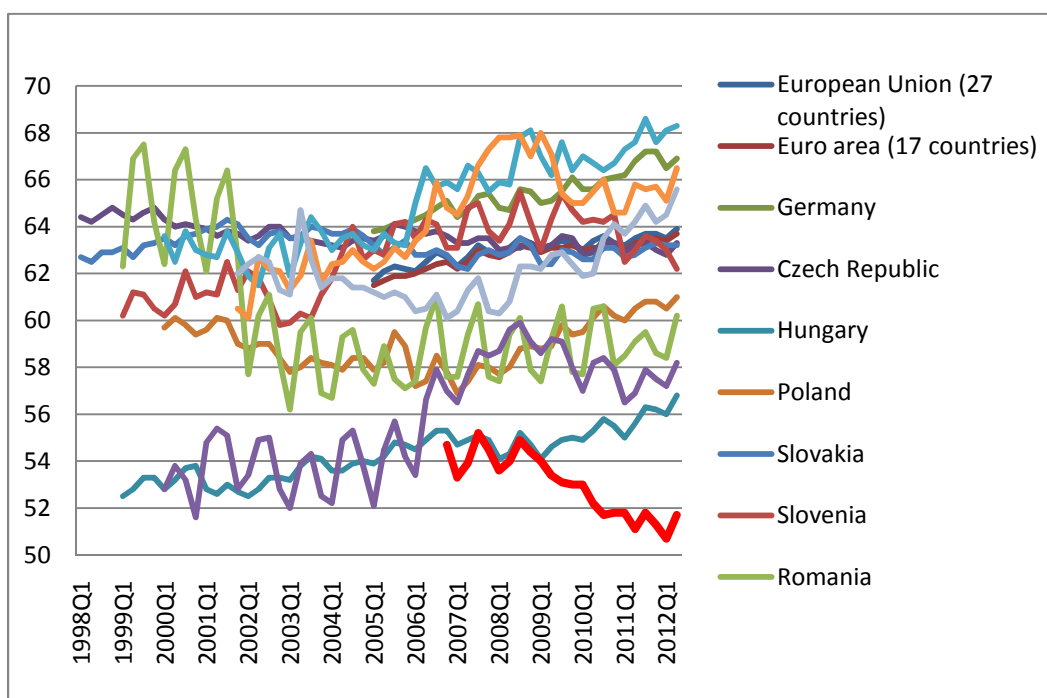
Chart 1. GDP growth in selected European economies (2000-2012), 2000 = 100%



Note: Based on quarterly GDP at market prices, adjusted seasonally and by working days

Source: Eurostat; f: forecast

Investments dropped from its peak in 2008 (27.9% of the GDP) to below 19% in 2012. In comparison, the EU-27 average was 21.1% in 2008 and forecasted to be 18.2% in 2012. Domestic demand is on the sledge as well, and expected only to grow in this year somewhat. Unemployment is growing continuously by reaching over 16% in the first quarter of 2012. In parallel, employment decreased by more than 12% since 2008. Thus, inflexible labour market seems to be responsible for most of Croatia's economic problems. By having a look at the region's worst rate of activity, it becomes even more obvious.

Chart 2. Activity rates in selected European countries (1998-2012)

Note: Between the age of 15 and 74 years;

Source: Eurostat;

As in many countries in the region, foreign trade and export could be a source of regaining economic prosperity. But in Croatia, export has never been as significant as it is in for example Hungary or Slovakia. Exports to GDP has always ranged between 33% and 44% in the past 17 years. In Hungary, Slovakia or Estonia it is over 90%. Even in Slovenia it is above 75%.

Tourism is rather important though. After the end of the war, incomes from tourism started to grow quickly as this sector needed relatively low investments. Surprisingly, these incomes seem to remain stable during the crisis, while import decreased substantially.

Table 1. Net trade and external balance on goods and services as % of the GDP (1993-2011)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Net trade	-6,5	-8,8	-14,6	-14,9	-22,9	-16,2	-14,3	-14,9	-17,8	-21,3	-23,2	-20,4	-20,9	-21,1	-21,9	-23,1	-16,6	-13,3	-14,2
External balance	-1,2	-0,1	-8,4	-6,6	-13,1	-6,9	-6,1	-3,1	-3,8	-8,2	-7,7	-6,2	-6,2	-6,7	-7,2	-7,8	-3,5	-0,5	-0,1
Difference	-5,3	-8,7	-6,2	-8,3	-9,8	-9,3	-8,1	-11,7	-14,0	-13,1	-15,5	-14,2	-14,6	-14,4	-14,6	-15,3	-13,1	-12,8	-14,1

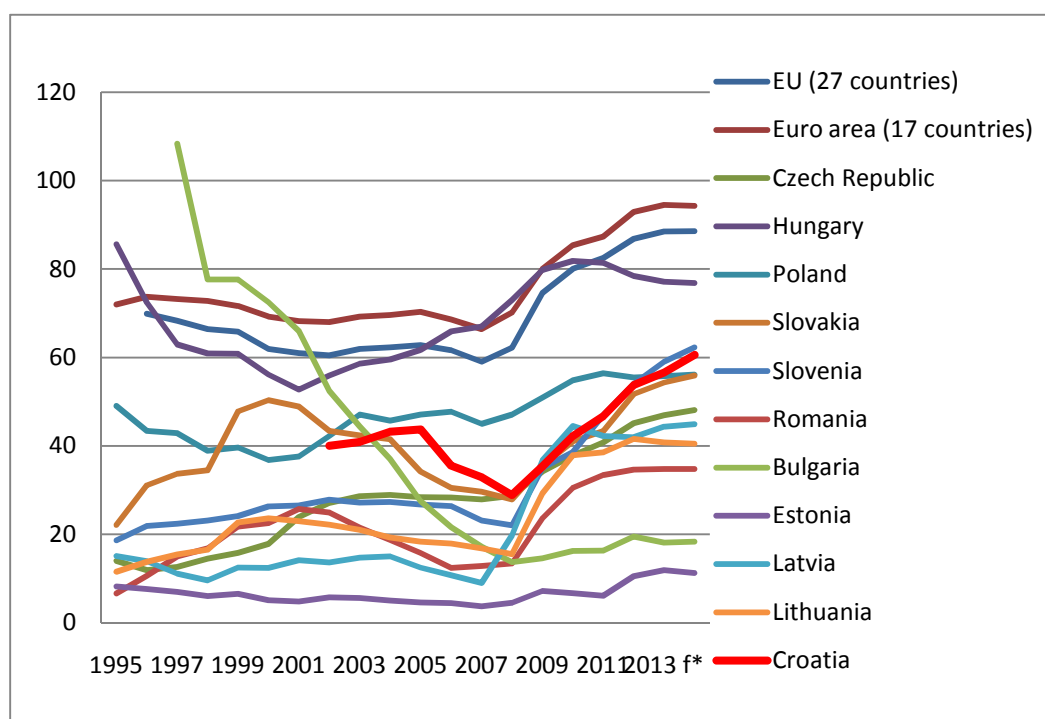
Source: World Bank

Stable foreign exchange income from tourism helped the Central Bank to maintain its currency regime as well. The Bank operates a managed floating system, where there is no explicit EUR/Kuna target rate, but it has ranged between 7 and 8 Kunas per Euro in the past 14 years, while foreign reserves could grow continuously.

Apart of the recession and the labour market situation, budget deficit and the rapidly growing public debt are the most important short term problems in the country. In the European Union only Slovakia and Slovenia had higher budget deficit in 2012 (4.9% and 4.4% respectively), but in 2013 Croatia forecasted to have the worst figure (4.2%).

Public debt to GDP grows rapidly. Between 2005 and 2008 Croatia successfully decreased its debt from 43.7% of the GDP to 28.9%, but then it started to grow sharply and forecasted to hit even 60% in 2014.

Chart 3. General Government total debt to GDP (%) in selected European economies (2000-2014)



Source: Eurostat; f*: forecast

One third of the gross government debt belongs to external creditors which equals 18.9% of the GDP at the end of November 2012. This is not an extreme high number however, Poland and Slovakia had 23.9% and 15.9% in 2011 respectively, both with quite similar public debt to GDP ratio.

The debt of Croatian banks to foreign creditors amounted 22.5% of the GDP, while other sectors' debt to foreigners stood at 44.4%. Thus, the economy's total debt to foreign creditors was 85.8% of the GDP. In comparison, the same ratio in 2011 was 43.6% in the Czech Republic, 62.3% in Poland, 71.5% in the Slovak Republic and 105.1% in Slovenia.

Consequently, the problem is not with the figures yet, but more like with the tendency and the lack of the possible sources of GDP growth. Beside short term austerity measures substantial reforms in the labour market would be essential.

“Slow-akia”? – Ministry of Finance cut Slovakia’s GDP forecasts

Péter Sulán

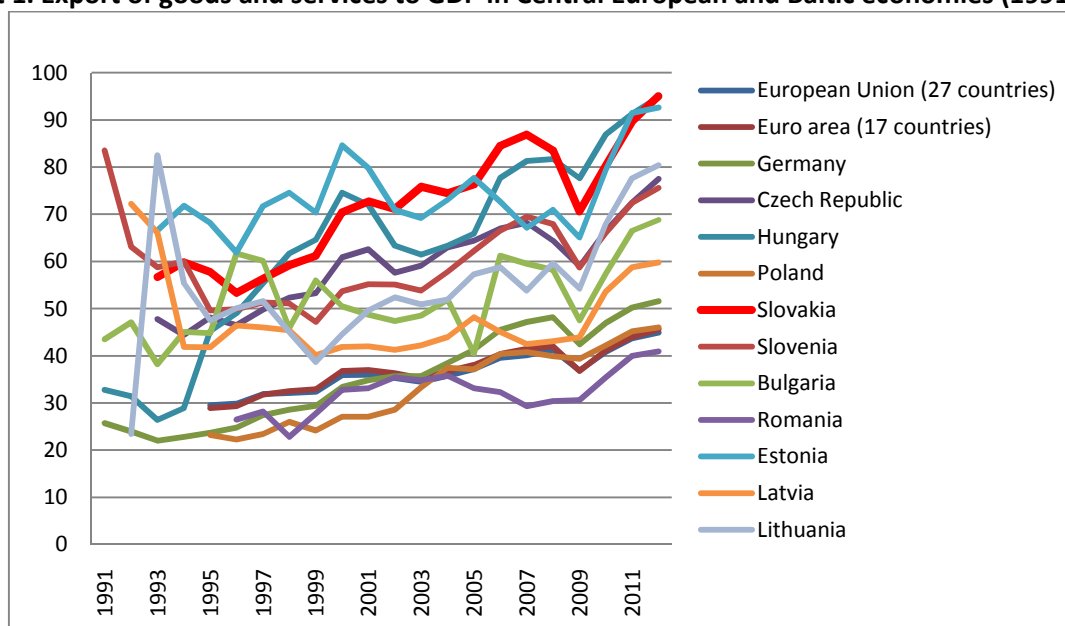
After years of outstanding Slovakian economic success the Ministry of Finance cut its GDP forecast recently. Growth rates were forecasted to be 2.1%, 3.5% and 3.6% for 2013, 2014 and 2015 respectively. The new outlook is 1.2% for this year, 2.9% for 2014 and 3.3% for 2015.

The country’s economic convergence started from quite low level. In 1992 per capita GDP stood only around 36% of the European average on purchasing power parity. The convergence accelerated especially from around 2000 and by now the country reaches nearly 70%.

The crisis has not hit the country as heavily as it hit many others in the region. Since the outbreak of the crisis there was only one quarter when the GDP fell on year on year basis – the 1st quarter of 2009, when it fell by 8.5%. By the end of 2011 GDP was already higher than it had been before 2008. Actually this is the second best performance in the region, followed by Poland.

Slovakia introduced the Euro right in the first phase of the crisis on 1st January 2009 which certainly affected the economy in many ways. Export has become more and more important for the country, figures improved significantly in the past 15 years. It was in fact one of the key factors in the economic success. Thus, in the years after 2008 a mixture of the increasing export demand, the increasing export capacity or the advantage of the single currency made a fast economic recovery possible.

Chart 1. Export of goods and services to GDP in Central European and Baltic economies (1991-2012)



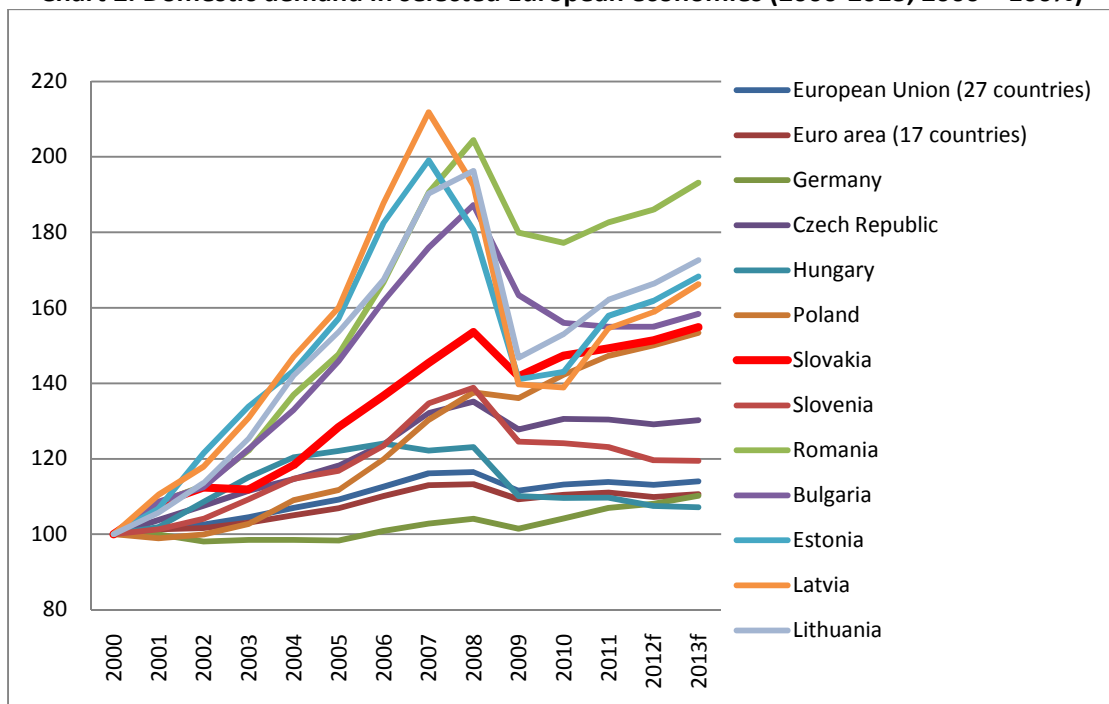
Source: Eurostat

Not incidentally, trade balance showed surplus in 2009, first time from 1994, and by 2011 the surplus reached 3.5% of the GDP. In the region only Hungary had higher surplus in 2011 (4% of the GDP). The external balance of goods and services also had 2.6% surplus in 2011.

High level of investments played an essential role in GDP growth as well. Gross fixed capital formation has never been lower than 20% of the GDP in the past 12 years, while investments in machinery hit 9.3% of the GDP in 2011, which was the highest figure in that year within the whole European Union.

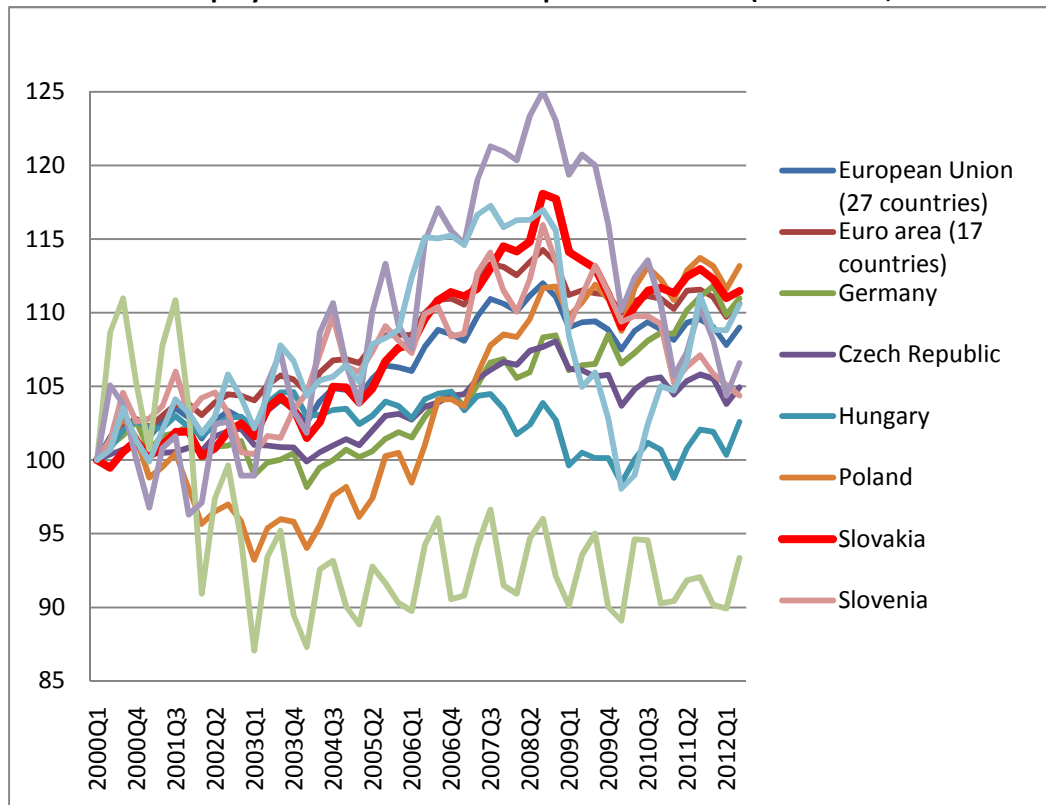
Beside the export figures, domestic demand also recovered fast after the outbreak of the crisis. In 2013 it forecasted to grow over its before-the-crisis level. Domestic demand has only recovered faster in Poland which is a rather different story.

Chart 2. Domestic demand in selected European economies (2000-2013, 2000 = 100%)



Source: Eurostat

Both in Poland and in Slovakia employment supported considerably the growth of domestic demand. As the chart below shows, Slovakia is quite successful in the region in preserving employment during the crisis.

Chart 3. Total employment* in selected European economies (2000-2013, 2000 = 100%)

Source: Eurostat; *: Resident population concept - LFS

In contrast, unemployment still remains high (over 13%). Even before the crisis, unemployment stood at around 9% and has never been under 8.5% in the past 15 years. This suggests severe structural problems in the labour market.

To sum up, Slovakia came out of the crisis quite well, compared to other economies in the region. On the other hand, the uncertain economic environment and the internal structural problems on the labour market hinder further fast growth in the coming years.