

Preface

This book discusses selected aspects of European economic integration from a global perspective, investigating the impact of China and Russia as emerging global economic players on the catching-up process in Central, Eastern and South-Eastern Europe (CESEE). Contributions focus on global imbalances and accompanying policy challenges, competitiveness and trade, the sustainability of current growth strategies, and banking and financial stability in the light of the economic and financial crisis that started to evolve in 2008.

To adopt this broader view of European economic integration is not only necessary because of the crisis in which spillovers and contagion are one of the major issues. Even under normal circumstances a country-by-country approach involves a certain risk: the risk of overlooking fundamental economic developments that take place elsewhere and might affect the CESEE region as a whole. Developments in Russia, and even more so in China, seem to fall into this category. Given their huge size and market potential alone, it is quite obvious that economic developments in these two countries will have an impact on the CESEE region. In turn, the CESEE region as a whole – and the euro area as well – may have an impact on Russia and China, too. Therefore we found it was high time to analyse this triangle of regions – CESEE, China and Russia.

China started to successfully enter the stage of the global economy in the 1990s and has since succeeded in delivering rather sophisticated goods to a number of markets. Sooner rather than later the emerging and developing economies will overtake the advanced economies in terms of output, thereby significantly shifting the balance of economic activity in the world. While this growing share necessarily comes at the expense of Europe and the USA, the global economy must not be understood as a zero-sum game. With China becoming more affluent, the export markets for European goods and services are growing, too.

China in particular has been recording impressively high growth rates, although admittedly from a low starting point. Still, as a result of its strong growth performance China will turn into an increasingly attractive destination for exports from the CESEE region. At the same time, however, the rising importance of the Chinese and Russian economies

represents a challenge in its own right. The main export destinations of China and the CESEE countries overlap, so that the two economic areas compete for the same markets.

Russia, another global player in Europe, has a key role in securing the supply of energy and thus in securing CESEE growth. But this richness in energy masks several economic challenges, and sometimes even prevents their solution: as there is a lack of productive investment, actual growth is rather unstable. Demographic developments are also worrying: Russia will see a serious decline not only in its population, but also in its labour force. Immigration will not suffice to compensate for this decline. Russia's current account increasingly depends on oil exports. As a consequence, oil prices have an impact on the balance of payments and, in turn, high oil price volatility leads to a high volatility of the exchange rate of the Russian ruble. Moreover, the federal budget heavily depends on oil revenues, contributing to the Dutch disease phenomenon.

In terms of trade, one of the key issues covered by this book, the intensification of already existing trade relationships has contributed most significantly to export growth from CESEE, China and Russia to the EU-15 market, with EU accession in particular temporarily leading to a notable contribution of new trade relationships to the export growth of the new EU countries. Regarding the commodity breakdown of exports to the EU-15, Russia has increasingly specialized in natural resources, while CESEE and China have diversified their export base, intensifying direct competition in capital goods, machinery and vehicles. In particular, CESEE shows a weaker competitiveness effect than China in one of its main export categories, which is transport equipment.

While the trade performance of the CESEE countries used to benefit from their proximity to the EU-15 and the low output volatility, trade with the EU-15 declined strongly in the course of the recent crisis. Compared with developments in other emerging market regions, CESEE exports have so far recovered less dynamically. At the same time, the trade integration of the CESEE countries with China has clearly increased during the crisis. One of the main challenges for future trade developments in CESEE is the ongoing improvement of the value-added content of their exports, which implies that the CESEE countries will be confronted with higher competition from other emerging markets, including China.

In general, global growth gravity is moving away from the advanced economies to the emerging economies, narrowing the gap between these two groups, while both are currently facing a growth slowdown. This development causes global demand structures to change as lifestyles in the emerging markets adjust to people's increasing incomes. Both trade patterns and global financial flows are becoming more emerging markets

oriented. China thus needs to adopt a new growth model based rather on domestic consumption than on external demand and investment. To this end, China needs to move up the value chain, open up its services sector and use fiscal policy to provide its people with solid education, health care and pension systems.

This demonstrates that China's growth model has had its merits as well as its limits, as the current approach has reached the point of diminishing returns. In the current global macro environment, the scope for export-led growth is constrained. Another reason for reducing the export contribution to growth is that the export sector is a very capital-intensive sector. The foreseeable reorientation of US demand away from consumption adds to this effect. China is facing a stark choice between bearing increasingly large capital losses in its foreign exchange reserves and tolerating immediate losses in terms of a significant drop in its current account surplus and large revaluation losses. Hence China would benefit from a reorientation toward domestic demand and from liberalizing the services sector. A faster appreciation of the Chinese yuan renminbi would not only reduce global imbalances, but would facilitate East Asian adjustment via the exchange rate channel.

The final section of the book is devoted to financial market issues. Next to trade, capital inflows and institution building, sound financial markets are a precondition for emerging market economies walking the catching-up path successfully. A comparison between the financial markets of all three regions shows significant differences. In CESEE, financial markets deepened continuously before the crisis, mostly with the support of foreign investments in the banking sector. During the crisis the banking sector was not heavily affected due to its business model – concentration on lending activities. In Russia, quite to the contrary, the presence of foreign banks is relatively low and banking sector developments depend on international financial markets rather than on European banking groups. With a GDP contribution of less than 10 per cent, Russia's financial sector is still weak, and for banking supervision there is still room to improve. China's financial markets are slowly but continuously opening up. They also proved to be an important element in weathering the storm during the crisis, as they kept on lending. Due to their peculiarities they can hardly be compared with banking sectors in other countries. In any case, all policy measures that helped to calm the situation in the global financial markets were also helpful in stabilizing the banking sectors of CESEE, Russia and China.

Overall, convergence not only in Europe, but also globally, takes time and requires constant efforts in order to be sustainable. Therefore maintaining competitiveness is key. Internal devaluation aimed at regaining competitiveness can work if the right conditions and policies are in place,

but it is generally not a recipe for the long run. Instead, strengthening the economy in each and every respect should be the motto. As shown by many examples in this book, economic integration with neighbouring countries, but also with those far away, pays off. The masterpiece is complete when this goes along with avoiding unbalanced growth and income.

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