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Germany-Central and Eastern Europe: The Old Continent's New Economic Core?

One of the most important phenomenon on the European continent after the end of the Cold War has been the re-inclusion of the Central and Eastern Europe into the German industrial bloodstream. It has not only resulted in an economic integration, but also in close political relations between the regional capitals and Berlin. The third decade will witness a development of the new EU's integration core based on strong ties between Germany and Poland together with the other Visegrad Group states or a significant loosening of these relationship as a result of building new economic alternatives, including with non-EU countries.

Despite the fact that economic ties between Germany and Central and Eastern Europe (CEE) nations have the centuries-old history, the present thinking about cooperation between these countries is still marked by the two World Wars and the former division of Europe into two hostile blocks. In the 70s, the policy of détente, with the West Germany's Ostpolitik above all, brought slow reestablishment of the broken ties. But it was the end of the Cold War together with accelerated globalisation that made the dynamic economic and political integration of Europe possible.
The accession of the 12 new countries to the EU, 10 of which located in the CEE, enabled reestablishment of ties between economies of the two parts of the once divided continent. It was of utmost significance for this process, that the strongest economy of the Western Europe - Germany was bounded with the four strongest countries from the centre - Czech Republic, Hungary, Poland and Slovakia.

Economic ties re-established

A quarter-century after the Round Table talks in Poland and the fall of the Berlin Wall, Germany is the most important trade partner for all CEE countries and contributes to approx. 24 percent of the regional international trade. At the same time, V4 countries (taken together) are more important trade partner for Germany than France, and the trade turnover with Poland alone is on a similar level to that with Russia. Germany holds dominant position in these countries statistics both on export, import as well as on foreign direct investments (FDI) and tourism. In case of Czech Republic in 2012, Germany was responsible for 28.5 percent of its trade turnover, including 31.3 percent of export and 25.3 percent of import. 22.0 percent of FDI (as of 2012) has flown to Czech Republic from Germany as well as 21.3 percent of tourists (in 2010) – which places Berlin on the first place in both of these categories.

Germany – the most important trade partner of Poland - is responsible for 23.0 percent of the Polish foreign trade turnover (in 2012), it covers 25.1 percent of Polish export and 21.1 of imports, holding first place in both of these categories. Concerning FDI, with the share of 15.0 percent (in 2012), Germany takes the first position, ahead of Netherlands (14.7 percent). Germans are the largest group of foreign tourists arriving to Poland - accounting for 32.4 percent of foreign arrivals in 2012. In case of Slovakia, in 2012 Germany accounted for 20.4 percent of foreign trade turnover, 22.4 percent of export and 18.0 percent of import. In each of these categories it holds the first place. As to FDI (11.2 percent share in 2011) and tourism (8.8 percent share of foreign arrivals in 2012) Germany was the third most important country. When it comes to Hungary, trade with Germany in 2012 accounted for 24.9 percent of its all foreign trade, which makes Berlin the most important trade partner. Germany was responsible for 24.7 percent of Hungarian export and 24.6 percent of its import in 2012 and also holds the first place on a list of major foreign investors - 23.0 percent of all FDI in 2012. With a share of 13.7 percent in 2012 - Germans were the largest group of foreign tourists arriving to Hungary.

Table 1

German Investments and Trade with CEE

Country	Germany's place - list of major export recipients	Germany's place - list of major exporters	Germany's place - list of major trade partners	Germany's place - list of major investors	Germany's place - list of tourists
Czech Republic	**1.** (31.4% in 2012)	**1.** (25.3%in 2012)	**1.** (28.5% in 2012)	**1.** (22% w 2012)	**1.** (21.3% in 2010)
Poland	**1.** (25.1% in 2012)	**1.** (21.1% in 2012)	**1.** (23.05% in 2012)	**2.** (13.5% in 2011)	**1.** (32.4 % in 2012)
Slovakia	**1.** (22.4% in 2012)	**1.** (18.5%)	**1.** (20.49% in 2012)	**3.** (12.2% in 2011)	**3.** (8.89% in 2012)
Hungary	**1.** (24.7% in 2012)	**1.** (24.6% in 2012)	**1.** (24.9% in 2012)	**1.** (23% in 2012)	**1.** (13.7% in 2012)

Source: Czech National Bank, Czech Statistical Office, Czechtourism, National Bank of Poland, KUKE, Polish Ministry of Sport and Tourism, National Bank of Slovakia, Statistical Office of the Slovak Republic, Hungarian Investment and Trade Agency, Australian Government Department of Foreign Affairs and Trade, Hungarian Central Statistical Office

The strength of the economic ties bounding CEE with Germany was revealed by the global financial crisis, when fluctuations of the German economy were immediately influencing the economic situation in the CEE region. This was the case in 2009, when the recession in Germany (GDP fall by 4.7 percent) spilled over on the economies of Czech Republic, Hungary and Slovakia, which shrank by 4.5 percent, 6.7 percent and 4.9 percent, respectfully. Thus, prime minister of Slovakia Robert Fico's words - "when something's going on in Germany in January, we feel it in Slovakia in July, this is a reality of my country"[1] - should not surprise anyone. The situation looks somewhat different in case of Poland, which on the one hand felt the economic downturn in Germany in 2008-2009 but the influence was not as strong as in the other CEE countries[2].

To Brussels via Berlin

The emergence of such strong economic ties between Germany and CEE countries in just two decades, makes one thinking about the causes of this phenomenon. It's important to take into account, that after the end of Cold War, the future of Germany-CEE relations was not all obvious. Moreover, a number of observers predicted, that the historical burdens would pose a serious obstacle for development of cooperation.

There are three factors that have played the decisive role in re-establishing economic ties between Germany and CEE:

1. centuries-old tradition of strong ties between Germany and the centre of Europe
2. integration of the bilateral relations into a frame of the accession process of CEE countries to the Western institutions – the European Union, but also NATO.
3. profitability that made German firms invest and trade with the firms from the region

As already mentioned Germany has been a part of the history of Central and Eastern Europe throughout many ages, with an economy as one of dimensions of its presence. Moreover, for ages it was Germany that played the role of a transmission belt of the Western civilisation to the East. The important process in the integration of both part of Europe was German settlement in middle ages. Between XII and XVII centuries German-speaking settlers had been founding villages and cities, applying their laws and other standards. The process resulted in a high inflow of German-speaking population, in particular into the major urban centres, in spreading out the German rule of laws as all as in the dynamic economic development of the region.

[1] J. Cienski, Central Europe Falls into Germany's Orbit, Center for European Policy Analysis, 19.06.2013.

[2] J. Olszyński, Implikacje kryzysu w Niemczech dla polsko-niemieckich stosunków gospodarczych i gospodarki Polski [Implications of the crisis in Germany for the Polish-German economic relations and the Polish economy], Zeszyty Naukowe Kolegium Gospodarki Światowej, tom 33, 2012, p. 88.

After the 1989 breakthrough, these centuries-old ties made Germany natural leader of the Western Europe in term of expertise and involvement into the affairs of eastern part of the continent. Germany's knowledge and historical experience would not have been as effectively used though, without the acceptance from the CEE countries of its growing presence in the region. In this context, it was of crucial importance for united Germany to take a clear stance on the issue of the responsibility for the Second World War (in case of Poland also to definitively recognize the border along Odra and Nysa rivers), but most importantly to play the role of the main advocate of the NATO and the EU enlargements to the East.

Germany's support for Poland's European and Atlantic aspirations formed the basis for the concept of "Polish-German community of interests" („deutsch-polnische Interessengemeinschaft"), which served as a cornerstone of bilateral relations after the disintegration of the Soviet Union. These bilateral relations were significantly strengthened by the German commitment (incorporated into The Polish-German Treaty of Good Neighbourship and Friendly Cooperation signed in 1991) to support Poland's integration into The European Communities. Despite the fact, that such declarations did not come easy for the German politicians, they still were much more in favour of the EU enlargement than their Western European colleagues. Given all these, the words of the foreign affairs minister Krzysztof Skubiszewski, who in the 1993 exposé in Sejm said: "it's desirable that the German capital, especially large corporation, are even more engaged in Poland", came as no surprise.

Historical and political factors made the development of the economic ties between Germany and CEE possible, but motivations of German companies to take advantage of business opportunities emerging through the last two decades, were obviously of purely economic nature.
The attractiveness of the region was based on: dynamic economic growth, which generated internal demand, stable and secure investments environment as well as well-educated and cheap labour force. Additionally, geographical proximity, cultural similarities and similar sectorial structure played an important role[3].

Mutual benefits

Currently, as indicated by the research conducted by the Polish-German Chamber of Industry and Commerce, for companies with a foreign capital operating in the CEE, the most important factors determining the attractiveness of the region are: EU membership, work force qualifications, their productivity and motivation as well as the quality of academic education and the quality and availability of local subcontractors[4].

The combination of these factors meant that during the over a 20-year period, German companies has moved the key stages of an industrial production to the CEE countries. It allowed them to maintain their competitiveness in the global market (especially given the increasing pressure from Asia), but also contributed to the modernization of the economies of the former Eastern bloc. What's more, the rise of strong economic ties translated into the political sphere. As a result Berlin has become the most important partner for the countries of the region.

The process of inclusion of the CEE into the German supply chains occurred through the participation of German companies in privatization processes, but mainly through greenfield investments in the production industries[5]. Given the structure of the German economy, in which the automotive and chemical industries play the dominant role, exactly those two industries have become the basis of the discussed ties.

Data on the exports from the CEE countries shows the strength of ties within the production chains in the automotive and transport sectors. Although in the period 1995 - 2008 exports from the region has increased in most major categories by more than 200 per cent, in the transport sector, this growth ranged between 700 and 2,200 per cent. Consequently, the share of exports of these products in total exports of Hungary, the Czech Republic and Slovakia increased from around 10 to more than 20 per cent[6].

[3] German-Central European Supply Chain– Cluster Report, IMF Country Report No. 13/263, August 2013.

[4] Survey (Ankieta koniunkturalna) CEE 2013, www.paiz.gov.pl

[5] German-Central European Supply Chain– Cluster Report, op.cit.

[6] Jesmin Rahman, Tianli Zhao, Export Performance in Europe: What Do We Know from Supply Links?, IMF Working Paper, March 2013.

Moreover, as another IMF report shows, shift of the industrial production to the East was accompanied by the transfer of technology and income convergence. In the knowledge-intense sectors, in terms of revealed comparative advantage[7], CEE countries (with the exception of Poland) has to a high degree catch up with Germany.

In addition, they surpassed in this respect some of the peripheral countries of the Eurozone, which during this period decreased their competitiveness (Ireland and Spain) or sustained comparative disadvantage (Greece and Portugal).

Table 2

Revealed Comparative Advantage (RCA) in Manufacturing

	Manufacturing 1995			Manufacturing 2009		
	Labour-intensive	Capital-intensive	Knowledge-intensive	Labour-intensive	Capital-intensive	Knowledge-intensive
Czech Republic	1.29	1.30	0.56	1.01	1.16	**1.18**
Hungary	0.68	1.06	0.50	0.37	0.77	**1.18**
Poland	1.95	1.39	0.59	1.52	1.39	**0.93**
Slovakia	1.05	1.61	0.60	1.16	1.41	**1.11**
Germany	0.64	1.07	1.48	0.64	1.20	**1.49**
Portugal	3.42	0.94	0.57	2.08	1.43	**0.60**
Spain	0.93	1.21	1.04	0.97	1.29	**0.98**
Ireland	0.34	1.79	1.01	0.11	0.72	**0.89**
Greece	1.56	1.26	0.03	0.33	0.72	**0.20**
China	3.55	1.03	0.64	2.52	0.66	**1.27**

Source: IMF Country Report No. 13/263, Rahman and Zhao (2013)

[7] Revealed Comparative Advantage represents a relation of the share in export of the analysed product or group of products (from a given country) in world trade to the share of this country total export's share in the global trade. RAC values above 1 means the country to specialize in a particular sector and less than 1 indicate a lack of comparative advantage in the industry.

As a result, export from the CEE countries has been growing fastest in knowledge-intensive sectors, including the aforementioned automotive, machinery as well chemical industries. In the Czech Republic, Hungary and Slovakia export growth in these areas, in the period 1995-2009, accounted for 50-60 percent of total export growth. In Poland, this percentage was slightly lower - 40 percent - though still the highest compared to other sectors[8]. In addition, participation of CEE in the supply chains was a driving force behind the process of income convergence between these countries and Germany, also resulting in the development of enterprises 'supporting' production plants within these structures.

All these do not change the fact that between the two parties there is still a large asymmetry in terms of value-added in manufactured goods and services. This imbalance is evident both in industry - where the Germans are largely responsible for the design and distribution and the CEE countries for assembly, as well as in services - German firms provide legal services, consulting and business while these from CEE mainly construction and transportation ones. Moreover, the wide opening of the economies made the discussed states more exposed to external shocks. This is particularly valid in case of smaller economies, which may be affected even by problems of single corporation. This dangerous relationship was experienced by Hungary, where factories of experiencing troubles Nokia and BlackBerry, are located.

Political leadership

Strong and multidimensional economic ties are usually reflected in the political sphere too. Therefore the growing role of Germany in foreign policies of the CEE countries together with a maturing sense of closeness of interests, recently reflected in the statements of regional politicians, is not surprising. Slovak Foreign Minister Miroslav Lajčák declared that his country would not have a problem in becoming a part of a "greater Germany". His Polish counterpart Radosław Sikorski stated that Germany has become "indispensable nation in Europe "and that he feared more the passive Germany than the powerful Germany". Former President Lech Wałęsa went even further, saying that "we should create one country of both Poland and Germany: Europe". Such statements also reflects the change in public mood in Poland - according to the research of the Institute of Public Affairs as much as 43 percent of Poles believe that the strengthening of Germany's position in Europe is favourable for Poland, the opposite view is shared by less than half this group - 21 per cent of responders[9].

Moreover, although the financial and economic crisis has caused many cracks in the EU structure, in the case of Germany and the CEE countries it has revealed the conflux of the views on the fundamental issues regarding economy and public finances, and thus on the recipe for recovery from the crisis. CEE countries - experienced in implementing painful fiscal reforms - supported the austerity policy advocated by the Berlin. The leader of this group has been Poland, which not only had budgetary 'golden rule' (limiting the possibility of indebtedness of the state) incorporated into its constitution many years ago, but also supported German ideas of the EU treaties reform allowing for a closer monitoring of member states' fiscal policies. As a result, an increasing number of commentators indicate to the shift of the main line of division within the EU from the East-West axis (the "old" and "new" member states), to the North-South line (economically stable countries versus these in debt).

[8] German - Central European Supply Chain, op. cit., p. 11.

[9] A. Łada, The Poles on Polish-German Relations and Germany's Role in Europe, Institute of Public Affairs 2012

Common future?

The overall balance of Central and Eastern Europe relations with Germany in the last quarter-century is positive. This assessment does not change the fact that the EU is currently facing serious challenges, which can significantly influence relations within the region. Paradoxically, the difficulties can arise both from maintenance of the strong ties between Germany and CEE, as well as from their potential loosening.

In the political sphere threat concerns remaining of the major countries in the region - Czech Republic, Hungary and Poland outside the Eurozone. Given more and more explicit formation of the "multi-speed" Union with the Eurozone as the core of the European integration, countries left outside can find themselves in an uncomfortable situation when their ties with the EU decision making centre will be dominated by one country - Germany. Such a growing dependency in foreign policy, even if the CEE countries preserve their good relations with Berlin, is an obviously dangerous situation. At the same time, commitments of the "new" EU countries to join the Eurozone (undertaken in the accession treaties) can cause internal political unrest, thus worsening the climate of cooperation within the EU.

Equally important question concerns the stability of the existing economic links, in the context of inevitably progressive convergence of the costs of labour. Although the currently operating supply chains are not based solely on a cheap labour, but rather on a combination of several factors, securing their position or moving up in the value chain require form regional companies to make further investments in a human capital and skills of their employees. The good example has been set by Czech Škoda (owned by Volkswagen), which has launched a special university for its employees.

The future of Central and Eastern Europe relations with Germany will therefore depend on the maturity of the political elites of these countries and their ability to reconcile the conflicting factors:

1. closing ranks of the some EU member states around Eurozone accompanied by a strong centrifugal and disintegration tendencies, both within the EU (Greece, United Kingdom) as well as inside some Member States (United Kingdom, Spain, Italy), which may push countries to look for the national path of economic development (i.e. Germany and BRICS, CEE and Russia)

2. levelling of living and working standards between the West and the East, with the growing differences along the North-South division line.

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