Foreign & Commonwealth Office

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How is the UK placed to take advantage of opportunities in Central and Eastern Europe?

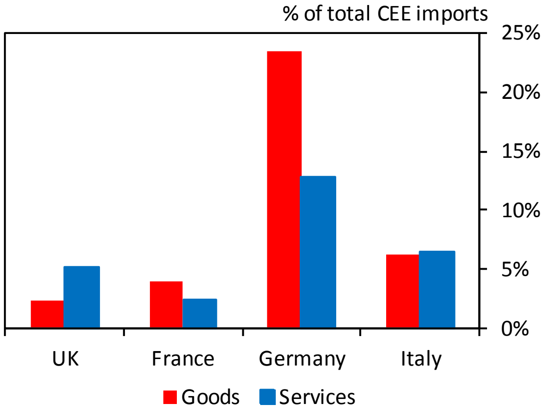
Summary

The emerging economies in Central and Eastern Europe (CEE)[1] are already a significant market- a population of some 140m potential customers with a GDP of around £1 trillion- and are set to see significant growth over the next five years, particularly compared to their western European counterparts**. To take advantage of that growth potential, the UK should look to catch up with the export performance of France, Italy and particularly Germany – the EU-3,** who currently export more to every CEE country than the UK.

How do we compare to our competitors?

We are also **well behind some of our closest European competitors**. Germany is by far the most successful, capturing almost a fifth of goods trade and around 13% of services. We are also outsold by both France and Italy in goods and are pretty much on a par with them in services. However, France and Germany, in particular, are larger economies than the UK so we would expect their market share to be bigger. In order to facilitate a fair comparison we have constructed an 'EU-3' benchmark (annex a). This is an average of German, French and Italian import shares, scaled to account for economy size.

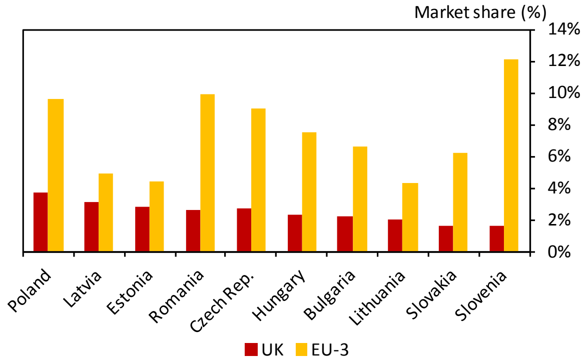
Chart 2: Average market share in CEE in 2010



Source: UNCTAD Statistics, ONS and FCO Economics Unit Calculations

[1] Poland, Latvia, Estonia, Romania, Czech Republic, Hungary, Bulgaria, Lithuania, Slovakia and Slovenia.

Chart 3: UK and EU-3 market share by country (scaled to account for economy size)



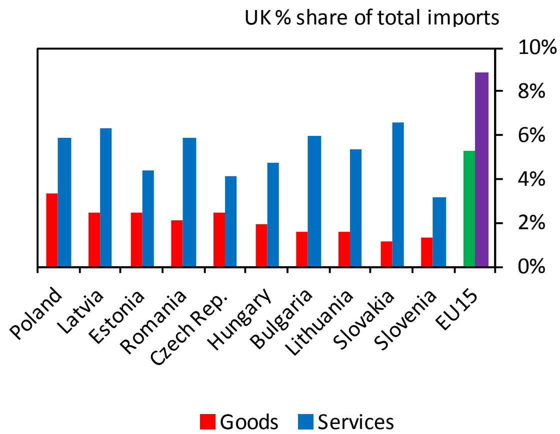
Source: UNCTAD Statistics, ONS and FCO Economics Unit Calculations

1. Chart 3 compares our total import share (goods and services) in each CEE country with the 'EU-3' benchmark. We have a lower market share in all CEE countries. In many cases the gap between the UK and the EU-3 is sizeable.

If the UK could match the performance of the EU-3 in this region by 2020 it would be worth **approximately £45bn per year**. This would be ambitious: EU-3 countries, particularly Germany, share historical and geographical links to CEE. However, **even closing half of the gap would bring gains of around £22bn a year**. **Encouraging more SMEs to export to the region and focusing on improving our services exports** would be two ways to unlock some of these substantial gains.

Where are we now?

Chart 1: UK share of import market in 2010

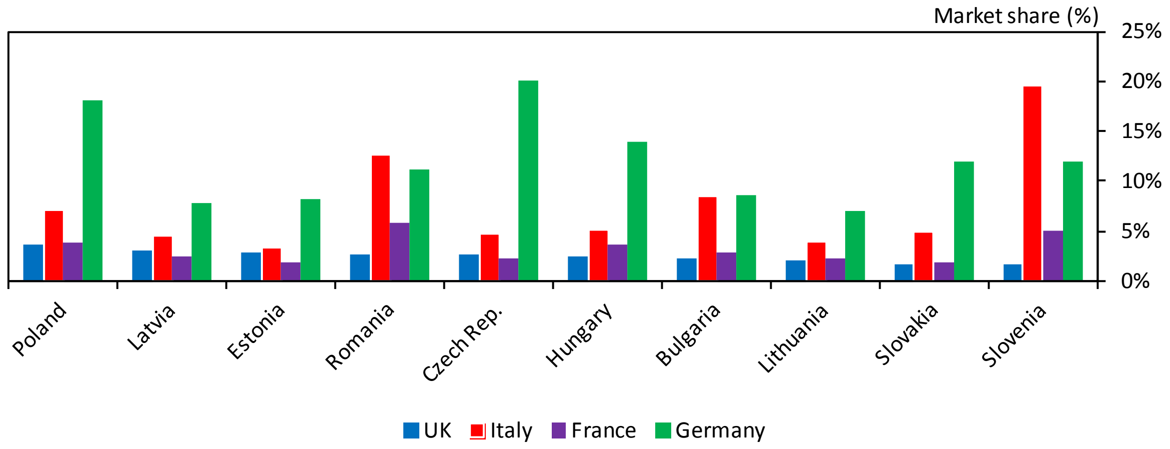


Source: UNCTAD Statistics and FCO Economics Unit Calculations

2. The UK currently captures around 2% of the CEE goods market and 5% of the CEE services market compared with a share of 5% and 9% respectively in the more established markets of EU15 members.

3. Chart 4 looks in more detail at the three countries in the benchmark after accounting for differences in the size of the economy. The UK is sells less in all markets than at least one of our three competitors and in many cases than all three of them. Geographic links are clear as Germany does very well with close neighbours such as Poland and the Czech Republic and Italy does very well in Slovenia. Historical and cultural links are also evident, particularly in the strength of Italian imports in Romania, where language similarities and familiarity with the Romanian public sector have helped Italian companies. Romanian companies also form a key component of Italian supply chains.

Chart 4: Market share by country (scaled to account for economy size)

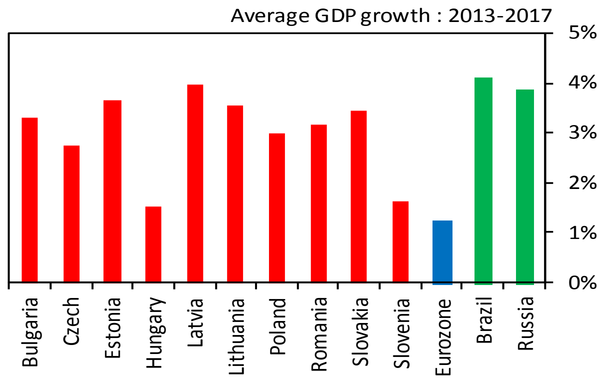


Source: UNCTAD Statistics, ONS and FCO Ecoomics Unit Calculations

Sizing the market - what is the growth potential in Central and Eastern Europe?

4. Most CEE economies have recovered well from the 2008 global economic crisis and are **forecast to see strong GDP growth relative to Euro zone economies** (see chart 5). A number of them will have growth rates which compare to the emerging powers Brazil and Russia.

Chart 5: Forecast GDP growth in CEE and the Euro Area: 2013-2017



Source: IMF World Economic Outlook October2012

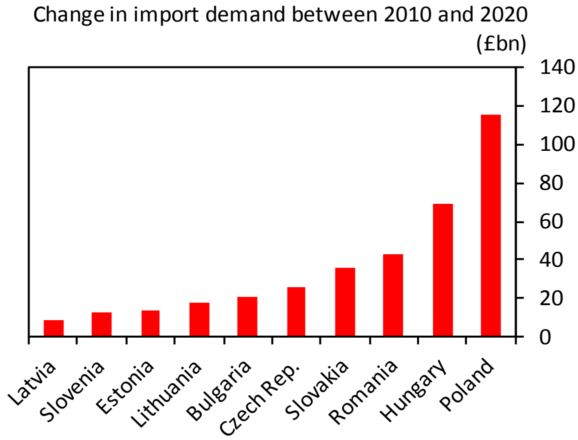
5. High growth in CEE economies will lead to rising import demand for goods and services. Between 2010 and 2020, Estonia is forecast to have the greatest increase in demand for imports of goods and services (table 1). Moreover, imports will double in five countries. This compares with average import growth of 43% over the same 10 years in the EU15.

Table 1: Expected growth in import demand 2010-2020

Country	10 years (2010-2020)
Estonia	144%
Bulgaria	115%
Lithuania	111%
Hungary	104%
Latvia	100%
Romania	97%
Poland	86%
Slovakia	76%
Slovenia	65%
Czech Rep.	31%
EU15	**43%**

Source: IMF World Economic Outlook October 2012, UNCTAD Statistics and FCO Economics Unit Calculations

Chart 6: Change in import demand, 2010 – 2020 $bn



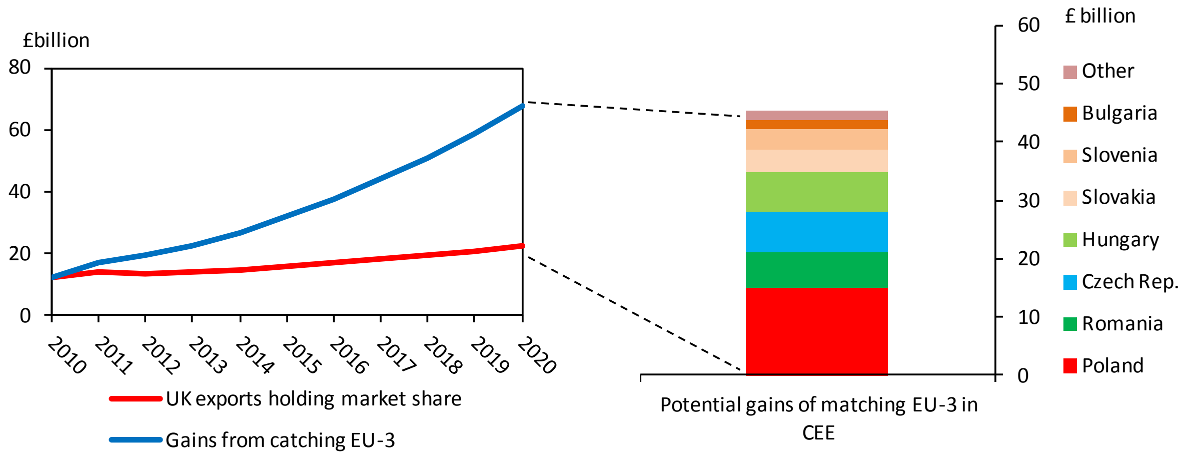
Source: IMF World Economic Outlook October 2012, UNCTAD Statistics and FCO Economics Unit Calculations

6. In monetary terms, it is the largest economies in the region that will see the largest increase in import demand (Chart 6). Polish import demand is forecast to be the largest reflecting both Poland's size and its growth potential. Romania and Hungary form a second tier and a third tier includes the Czech Republic, Slovakia and Bulgaria.

Matching our competitors: the prize

7. As a result **the potential gains from matching our competitors are substantial.** Chart 7 shows a forecast of UK and EU-3 exports up to 2020. The red line shows how UK exports to CEE would evolve if we maintained our market share. The blue line shows an indicative pathway to catch up with the EU-3 by 2020. Assuming that we had caught up with the EU-3 by 2020 this would **lead to gains of around £45bn.**

Chart 7: Potential gains from matching the EU-3 Market Share (exports to CEE, £bn)



Source: IMF World Economic Outlook October2012, UNCTAD Statistics and FCO Economics Unit Calculations

The potential gains of matching the EU-3 vary enormously between countries. Chart 7 also shows that the gains from Poland alone would total £15bn and **around 80% of the overall gains could come from Poland, Romania, Czech Republic and Hungary.**

Is it achievable?

8. Matching the exports of our European competitors in the CEE region is ambitious. There are geographical and historical links (particularly with Germany) which need to be considered when thinking about what is feasible.

9. If we take the example of Poland, as the largest of the CEE economies, Germany is Poland's largest trading partner, exporting almost 5 times as much to the country as the UK. Germany accounted for 21.6% of total inward Polish FDI in 2010 while the UK accounted for just 5.3%. Over 300 German companies have invested in Poland's 'Special Economic Zones' (selected regions offering preferential business conditions) compared to just seven UK companies. Finally, German companies have been involved in the privatisation of 83 Polish companies since 1990 while UK companies were involved in just 10.

10. Nonetheless, UK-Poland links have flourished since 2004 when we allowed free movement of workers from accession states. The ONS estimates an eightfold increase of Polish-born people in employment in the UK between 2004-2010. The growth of a **significant Polish diaspora in the UK** is reflected in vastly improved air links between the two countries, amongst other signs of progress. The diaspora is a source of potentially lucrative business and commercial networks for UK businesses.

11. In addition to strong links with the EU-3, some of the sectors identified as high growth for the CEE region, such as transport and energy, play more to their comparative advantage. However**, even closing half the gap with the EU-3 would add around £22bn a year to UK GDP** and this paper briefly highlights two potential areas where we could look to improve.

12. Firstly, encouraging more UK SMEs to export to the region would definitely help to unlock some of the potential gains. While a number of large UK firms have succeeded in the region, **the penetration of SMEs is low in many countries**. For example, around 40% of German SMEs export to Poland while in the UK it is only around 1%.

13. Secondly, **focusing on where we could compete in the provision of services** could also help to deliver substantial gains. The UK generally has a comparative advantage in the provision of services, particularly business and financial services, but Germany currently provides a higher level of services to a number of CEE economies. Matching the performance of Germany in the provision of services **could be worth around £9bn in 2020,** assuming the share of services in total exports remained constant. It would be worth even more if demand for services grows at a faster rate than demand for goods.

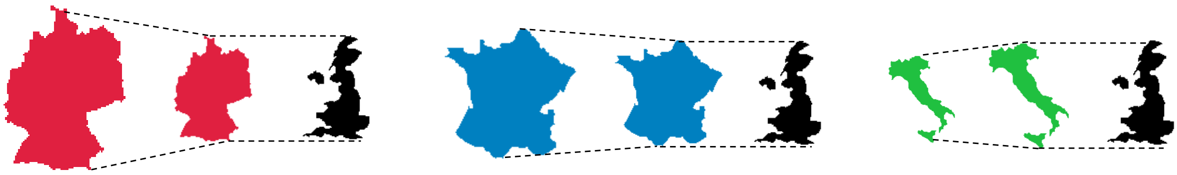
14. To realise the potential from this fast-growing region on our 'doorstep' two further areas in particular warrant mention. One is better exploitation of **local and EU supply chains**. The other is to tap into the large disbursements of **EU structural funds** in CEE states by offering consultancy or by bidding for the implementation of projects.

Annex – Calculating the EU-3 Benchmark

Who are out closest competitors? We compare the UK's export performance against the three largest European economies – Germany, France and Italy, (EU-3).

Why the EU-3? Germany, France and Italy are some of the UK's closest competitors, in geographical terms and in terms of the goods and services which we produce. Our economies are not identical but they provide a useful benchmark against which to assess our own economic performance.

How do you account for differences in size? To make them more comparable to the UK, we normalise the EU-3 results by scaling them to match the UK's economic size. German and French exports are scaled down, Italian exports scaled up:



The German economy is 46% larger than the UK

The French economy is 14% larger than the UK

The Italian economy is 9% smaller than the UK

What about idiosyncrasies? We average our results across the EU-3 to control for the fact that some markets have unusually strong links i.e. Germany and Poland or Italy and Slovenia.

So what is your benchmark? It's the normalised average of the EU-3: