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Central Eastern Europe five years after: from 'emerging Europe' to 'submerging' Europe?

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Policy implications

Central Eastern European (CEE) new member states were shaken by the crisis and some of them, in the most turbulent periods, were even haunted by the spectre of state bankruptcy. Any such developments would pose a real threat to the whole of Europe and would undermine the foundations of the European idea. The crisis in CEE highlights the one-sidedness of European integration, with deep economic and trade integration amplifying the negative effects from Western Europe, while political and social integration is lacking to fend off the consequences. Policy responses from Europe were neither timely nor adequate and the initiative was left to a large extent to the International Monetary Fund. This fact is itself evidence of political weakness, revealing the naked reality of a Europe lacking efficient union-wide institutions. The conditionalities of the IMF bail-outs, entailing severe and rigidly applied spending cuts, undermine fragile welfare systems, threaten escalation of the crisis as well as political and social stability in the entire region. Europe needs to do more and a crisis intervention fund needs to be established to avoid a potential failure of any of its member states.

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Introduction

For the eight Central Eastern European countries (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia), the fifth anniversary of EU accession has been marked by the devastating effect of the worldwide financial and economic crisis that is sweeping through the region. Bulgaria and Romania, which joined the EU in January 2007, are equally affected. We focus our attention here on the ten CEE new member states which entered during the last two enlargement rounds, with some additional references to the Ukraine which paints an alarming picture of how bad the crisis can get.

The contagion generated by the US sub-prime mortgage market spread, via different channels of opaque financial instruments, around the whole world (see more in Watt, 2008). The main effect was that 'toxic assets' have caused huge losses in the books of financial institutions and the previously abundant liquidity has turned into a credit crunch paralysing the entire banking system, not only in the US and Europe, but worldwide. The contagion has engulfed the European banking system and the dramatic effects of the financial crisis on the European economy have surprised everybody.

It had at first been thought that CEE new member states would not be affected by the spreading financial turmoil as their financial institutions were not involved in the opaque financial transactions characteristic of the US and most western banks.

Macroeconomic imbalances, chronic dependence on external financing and a high level of economic and trade integration with the EU15 were the underlying reasons why CEE new member states suddenly found themselves deeply affected. They were hit hard within a short time due to a series of factors that highlighted how previous high growth became unsustainable once the external environment took a turn for the worse.

In the next sections we show the major effects of the crisis on the CEE new member states with an overview of the factors of their vulnerability as underlying reasons for the intensity of the downturn. Then we address policy responses and implications and consider the prospects and impliciations for the process of European integration.

Economic growth and employment

In the past few years it has been taken for granted that a convergence process of CEE transformation economies towards the standards and realities of developed Western Europe was taking place. Their average growth rates over the last decade were characteristically between 4 and 5 per cent, with Slovakia and the Baltic states attaining growth dynamics of up to 10 per cent in certain years. Productivity was soaring and national currencies (those not pegged to the Euro) were undergoing a real effective appreciation. The dramatic effects of the crisis on the CEE region now call into question the sustainability of this economic and social convergence process.

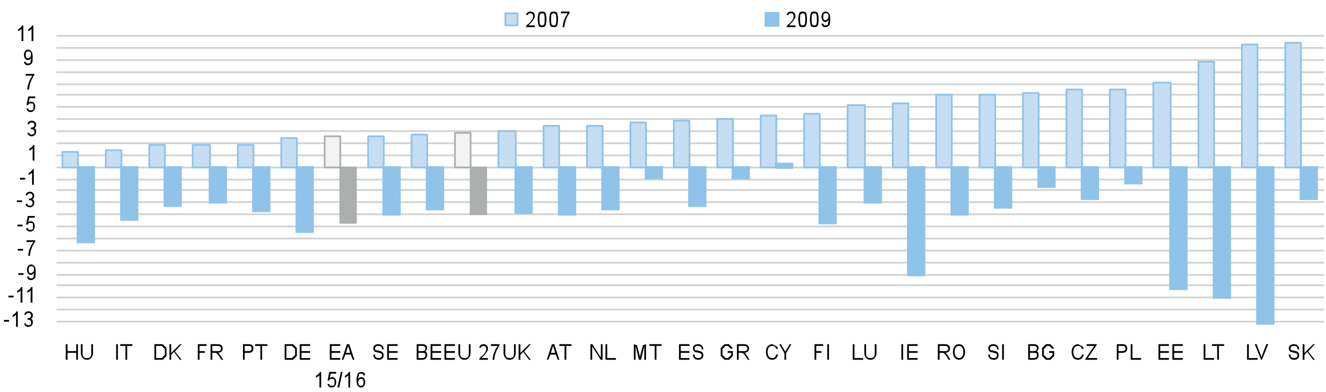
The 'hard landing' of 2009 from high growth levels in 2007 is visible in Figure 1 based on the May 2009 Forecast of the Commission (European Commission 2009).

Some of the CEE new member states are particularly hard-hit. The most dramatic downturn is foreseen in Latvia, where above 10% GDP growth in 2007 is likely to turn into a decrease of 13.1% by 2009. Previous high-growth economies, such as Estonia and Lithuania, are also expected to suffer, with a projected drop in GDP of 10.3 and 11% in 2009, while the 6.3% fall for Hungary is also substantial.

Employment creation had been very weak in central and eastern Europe even in the boom years, as illustrated by Figure 2. Both the US and the EU15 have had higher increases of employment with a fraction of the growth found in the new member states.

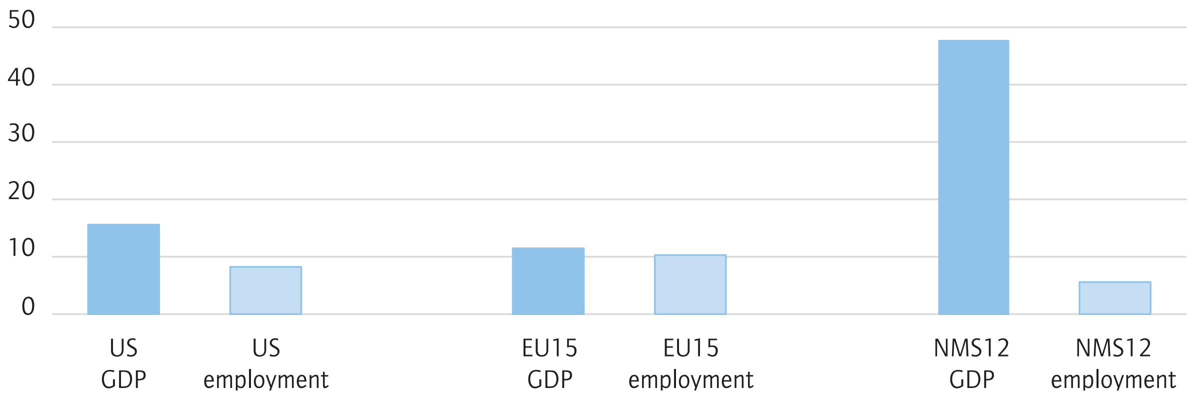
Now jobs are disappearing on a massive scale. Unemployment in Latvia, Lithuania and Estonia has doubled within one year, jumping to over 12% in Latvia and to nearly 10% in Lithuania and Estonia by early 2009. The unemployment rate in Hungary

Figure 1 **Gross domestic product in 2007 and prognosis for 2009 (annual growth)**



Data Source: European Commission (2009)

Figure 2 **GDP and employment growth in the US, EU-15 and NMS-12, cumulative % change 1999-2008**



Data source: European Commission (2008)

and in Slovakia did not show such dramatic changes but the levels were already close to 10%.

Factors of vulnerability of CEE economies

Soon after the crash of the Lehman Brothers in mid-September 2008, it turned out how vulnerable the CEE new member states indeed were and the figures on growth and employment have given an indication of this. The underlying reasons for these severe effects are rooted in these economies' vulnerability, the most important factors of which will be addressed in the next sections.

Macroeconomic imbalances at times of financial turbulence

With the continuing paucity of domestic capital, 'catching-up economies' have been notoriously reliant on external capital throughout the whole transformation process. This included foreign direct investments (FDI), financial investments (into state bonds and diverse corporate assets), foreign bank and government loans and EU transfers. This high external financing need made these countries dependent on the available abundance of investment capital and high risk-taking attitudes of investors. Current account deficits in most CEE countries had been notoriously high and in certain countries this was accompanied by high external debt levels. In a number of countries consumption was largely financed by credits, while especially those countries with a pegged currency witnessed high price and wage inflation together with rising asset (especially house) prices. Although government debt (that used previously to be the focus of attention) is substantially lower for most CEE countries than is usually the case for developed economies, their total external debt including enterprise and household debt has reached high levels in the most recent period. Table 1 shows current account balances for 2008 and for 2009 and also indicates levels of total external financing need (see more on current account deficits in the region in Shelburne, 2008).

After the shockwaves of the credit crunch and the bankruptcies in the US and the western European financial system, investors' confidence and appetite for risk suddenly evaporated. With growing risk aversion, foreign investors turned their backs on emerging market assets (including government securities) and retreated to their domestic markets. According to the Bank for International Settlements (BIS), US investors alone repatriated 750 billion USD in the last three quarters of 2008 (Financial Times 2009a). BIS data also reveal that cross-border lending by banks shrank by 4,800 billion USD in the first nine months of 2008. According to the IMF, the retreat from cross-border exposures is occurring more rapidly than the overall deleveraging process (Financial Times 2009b). The financing need of the stimulus packages of G7 economies might also add to the diversion of money flows from CEE financial markets, as the amount of state bond issues in the G7 economies is estimated to grow from 1000 bn USD in 2008 to 3000 bn USD in 2009.

Table 1 **Financial indicators for selected CEE countries**

Country	GDP/capita 2008, USD PPS	Financing need, % GDP[1]	Current account balance, % GDP[2] 2008	2009	Export share in GDP (2008)	5-year CDS[3]	S&P credit rating
Bulgaria	12,372	29.4	-24	-12.9	61.0	617	A
Czech Rep	25,757	9.4	-3.5	-2.8	80.1	309	AA
Estonia	20,754	20.0	-10	-6.3	72.0	700	AA
Hungary	19,830	29.9	-6.5	-3.9	80.2	574	A
Latvia	17,801	24.3	-14	-6.7	46.6	1,001	BBB
Lithuania	18,855	27.1	-12	-4.8	59.0	833	A+
Poland	17,560	13.2	-5	-4.9	42.3	387	A+
Romania	12,698	20.2	-12	-7.5	34.4	719	BBB+
Slovakia	22,242	12.5	-6	n.a.	90.5	222	AAA
Slovenia	28,894	n.a.	-6	n.a.	70.5	206	AAA
Ukraine	7,634	16.1	-6.5	0.6	45.0	3,899	CCC+

1 Total financing requirement, current account balance, principal due on public and private debts plus IMF debits, 2008 estimate
2 IMF prognosis
3 5-year credit default swap spreads in basis points

Source: *The Economist*, February 28th, 2009 based on IMF, Moody's and the *Financial Times*, 27th February 2009 based on Thomson Datastream

As a result, financial markets in emerging Europe came under huge pressure and daily debt financing has suddenly become difficult. National currencies were shaken with devaluations of up to 50% in the case of the Ukrainean Hrivnia, while the Polish Zloty, Hungarian Forint, Czech Koruna, and Romanian Lei also suffered setbacks of up to 20-25%. Credit ratings of state bonds were downgraded and country risk indicators deteriorated sharply, resulting in high interest rate margins, making debt financing difficult or in certain cases impossible. Default risk of state bonds is indicated by 'credit default swap speads' (CDS) which express the probability of state insolvency that in case of the Ukraine is estimated at 39%, and in that of Latvia 10% (Table 1). State bonds of Latvia, Romania, Serbia and Ukraine are meanwhile rated as 'junk bonds' (the rating B and under, as indicated in Table 1). These developments triggered further devaluations of regional currencies (not only those of the affected countries) launching a vicious circle and contagion across the region.

The role of western banks in the region

Over 80% of the banks of Central and Eastern European countries are affiliates of Western banks. These banks were eager to grant credits on a mass scale to the population and to enterprises in all countries of the region, often denominated in foreign currency (especially in countries where interest rates in local currency were substantially higher). According to a study by the Centre for European Policy Studies (Gros 2009), the residential mortgage debt in the so-called Visegrad Four (V4) countries – the Czech Republic, Hungary, Poland and Slovakia ranges between 11.7% of GDP in Poland and 15.3 in the Czech Republic, while levels in the Baltic states are over 30% (Latvia 33.7%; Estonia 36.3%).

Western banks made extraordinary profits in the region with profit levels more than twice as high as in their home countries and were expecting continued expansion in the region, even when the financial crisis was just around the corner. An analysis by the Deutsche Bank (Mühlberger 2007), dated December 2007, has seen huge growth perspectives for the central-east European banking sector with a credit expansion of 23% on yearly average until 2011. It also pointed to the underdeveloped nature of these banking systems, measured by the low levels of aggregated credit volumes (85%) compared to their GDP considering the usual levels in Western Europe (for the Eurozone: 230%).

The current situation is that, as a result of falling GDP, rising unemployment and weaker national currencies, the share of non-performing loans is rising and credit placements to CEE have become 'toxic assets' for Western banks. Austrian banks have outstanding credits at their branch offices in eastern Europe equalling up to 80% of Austrian GDP. Eastern borrowers must repay $400 billion in debt owed to Western banks during 2009. Western headquarters (themselves in trouble) were reluctant to bail out their eastern affiliates and even to continue credit provision.

Emerging Europe has thus been hit hard by global deleveraging and frozen cross-border bank lending. The impact has flowed through the same financial linkages with mature markets that previously allowed the region to build up a high degree of leverage through rapid foreign-financed credit growth. Cross-border bank funding is now being disrupted as the banking crisis in Western Europe intensifies. Growth in credit to the private sector is falling rapidly, intensifying the vicious circle between output declines and deteriorating asset quality (IMF 2009).

With household debt in several new member states (such as Hungary and Romania, for example) largely denominated in foreign exchange, as a consequence of currency devaluations of 20-25%, families face debt services that are up to 25% higher than originally planned. According to a recent poll by Nielsen Research (Napi 2009), 40 per cent of Hungarian adults have a bank credit, mostly denominated in foreign currency. In April 2009 49 per cent thought, it would require serious efforts to repay their debt, while 11% thought they might be unable to do so. This is no longer just a problem of financial stability but a burning social issue.

Deep economic and trade integration with the West

In most of the region growth and modernisation were largely driven by foreign direct investment. Levels of FDI stock reached nearly 100% of GDP in certain CEE countries (e.g. Estonia, Hungary and the Czech Republic), while almost all have their FDI stock over 50% of GDP. According to recent estimates of the Institute of International Finance, FDI flows to the region are likely to be reduced from 393 billion USD in 2007 to around 220 billion USD in 2009.

Though FDI was, on the one hand, an indispensable modernisation lever, it resulted in a dependent economic position with strategic decisions made at Western company headquarters and profit repatriation practices having a negative impact on current account balances. This factor adds to their vulnerability under stormy conditions.

Moreover, the economies of the new member states are integrated with the European and the world economy to a greater extent than most EU-15 economies and so are highly dependent on external demand. It had not been thought previously that the particular pattern of their economic and trade integration with Western Europe – that relies to a great extent on manufacturing – might become a risk factor. The high dependence on exports of intermediary manufacturing products to Western Europe and other developed economies is, in particular, the major factor currently depressing growth prospects (export shares of CEE countries are shown in Table 1). The new member states from Central and Eastern Europe and specifically the so-called Visegrad Four countries are particularly exposed to the breakdown of demand from the West, particularly from Germany.

The large automobile production capacities established in the Visegrad countries are highly dependent on the economic cycle, but also on their parent companies in Western Europe (in a few cases in Japan, Korea or the US). The electronic components industry (an important part of manufacturing not only in V4 countries and Romania but also in the Baltic states), and especially contract manufacturers, are even more exposed to economic cycles. As these industries constitute a large part of the reshaped industrial landscape in the new member states, they are vulnerable to external shocks. Developments in Germany are crucially important for the CEE new member states as most industrial investments and most of their industrial exports involve Germany. The severe downturn in Germany estimated by the latest forecast to -6% for 2009 has dramatic effects for most new member states.

The dependent position also appears on the micro-level, as a large part of CEE economies are dominated by foreign multinational enterprises with strategic decisions made at the Western company headquarters.

The new member state affiliates of Western multinationals have adopted plant-level adjustment measures similar to those applied by their Western European parent companies, but with a heavier hand and less based on negotiation with social partners. The plant-level effects of the crisis in central and eastern Europe are also harder than in the West, as less cushioning tools for the shock – in terms of labour market policy and collective bargaining instruments – exist. Only Hungary and Bulgaria have hastily adopted a specific labour market policy measure with public support to shortened working time along the lines of schemes existing in a number of EU15 countries. No other central and eastern European country has corresponding measures in effect or in planning (see more on plant level effects in Glassner and Galgoczi 2009).

Policy responses

European policy responses to the crisis in Central Eastern Europe were not timely or satisfactory and the European Union has left the initiative to the IMF. The most dramatic and immediate effects of the crisis on CEE were due to the paralysis of financial markets and required immediate intervention.

Hungary and Latvia - followed by Romania - had to turn to the IMF for an emergency loan by the end of 2008 in order to fend off the immediate consequences caused by the financial turbulence and bottlenecks.

The conditionalities of the €7.5 billion IMF package for Latvia speak for themselves: a 20 per cent cut in wages in public administration, similar cuts in teachers' wages, pensions and health spending. In view of the deteriorating growth prospects and the likely failure to meet the agreed 5 per cent budget deficit target, further cuts were held necessary in order to gain access to another tranche of the loan.

In the case of Hungary, the €20 bn emergency credit package (€12.5 billion IMF, €6.5 billion EU and €1 billion World Bank) included conditions to cut budget spending including pensions and social allowances to meet a 2.9 per cent government deficit target. While it is reasonable to raise conditions of sound finances for countries with a problematic past fiscal record, the lack of differentiation and rigidity of the application is threatening the objective of the whole operation. Sticking to a deficit target below 3 per cent at times of further downward corrections of growth prospects and when most of the Eurozone maintains substantially higher deficit levels to cope with the immediate effects of the crisis, cannot be seen as responsible policy.

Other financial support schemes were also initiated outside the EU framework, including the pledge of up to €24.5 billion in 2009 and 2010 by the European Bank for Reconstruction and Development, the European Investment Bank, and the World Bank to support banking sectors and bank lending to enterprises in emerging Europe.

The reliance of the EU on the IMF is itself evidence of political weakness, an indirect admission that Europe lacks union-wide financial institutions with the clout to deliver effective bail-outs. Considering the IMF's record with regard to the consequences of its bail-outs in developing countries, even if the recently undergone learning process is taken into account, the conditionalities of the support pose risks to these countries' mid-term development and cannot be seen as based on values in line with the European idea.

The speed-up of access to the resources of the European Social Fund was a useful measure but, given the magnitude of the crisis, cannot be regarded as any more than a symbolic gesture. The decision by the European Union to increase crisis support to non-euro members, albeit with adverse conditionalities, was welcome. As stated in the ETUC document to the Executive Committee (ETUC 2009): 'In exchange for foreign currency loans, countries are forced to cut anything that is social: wages, social spending, workers' rights, public services. Moreover, access to the Commission's €25 billion balance of payment fund is conditional upon respecting the IMF adjustment programme. European funds are being used to help the IMF to cut down the social dimension in Europe'.

The lack of European co-ordination on national financial support measures for parent banks to take into account the risk of introducing home bias that may stifle the timely resumption of banking inflows to their foreign subsidiaries was also a failure with adverse effects on the CEE region, where Western banks have risky credit placements. The absence of clear rules for cross-border crisis management and burden-sharing raises uncertainty about the recapitalization of foreign-owned subsidiaries.

The decision of the EU summit at the end of February not to provide co-ordinated help to CEE new member states was also a negative message to the region.
Although the decision by the G-20 to substantially increase the resources of the IMF and provide other forms of finance (such as a Flexible Credit Line) to emerging markets is an important step, at the same time it highlights the inability and paralysis of the EU and delivers the CEE region even more to the non-EU policy influence. This cannot be seen as an excuse for the EU not to commit itself more decisively in favour of the troubled region.

Concluding remarks

We have identified a number of factors that make CEE new member states particularly exposed to the current economic crisis. Depending on the situation of the particular country, these different factors in some cases combine into a toxic and explosive mix with wide-ranging consequences for the whole of Europe.

High reliance on external finances, as well as indebtedness of the government, the population and the enterprises, made some of these countries particularly vulnerable to external financial shock. On top of that, the high level of economic and trade integration means that the global shock is rapidly transmitted to the national economies. Employment creation had never been a strong phenomenon in these countries, even in the years of high growth. Existing employment is less secure and welfare institutions afford less coverage. Mass unemployment and growing poverty is a real danger.

Beyond the financial aspects, the crisis also has other serious effects, most of them due to the high level of economic integration of the region, as mentioned earlier. The current situation perfectly illustrates the adverse effects of economic integration without social and political integration. Weak social welfare systems in the CEE region are being further dismantled at times when Western Europe claims to be more resistant to the crisis than Anglo-Saxon economies due to the higher level of automatic stabilizers. Perversely, the discredited neo-liberal economic doctrine seems to be further strengthened in the new member states, while developed Western economies seem to be leaving it behind. All this is happening at the initiative or with the support of the European Commission. This strategy should be fundamentally revised.

Basic European values, such as solidarity and the idea of social Europe, were undermined by the adverse conditionalities attached by the EU (or left to the IMF) to its limited support. People's faith, five years ago, that the EU Eastern enlargement would lead to economic and social convergence towards the rich EU15 member state economies has been seriously shaken. Indeed, the lack of proper European responses to the crisis with its severe impact on the new member states could well call the future of a united Europe into question.

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