

THE GLOBAL ECONOMIC CRISES: IMPACTS ON EASTERN EUROPE*

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The global crisis of 2007–2009 can be viewed as three interdependent and mutually reinforcing crises: a financial crisis, a liquidity crisis, and a crisis in the real economy. The ten East European countries that are now EU members were hit first by the global liquidity crisis, then by dramatic declines in capital inflows and plunging demand for their exports. Different impacts among the ten are explained by such factors as their exchange rate regimes, the extent to which households found it advantageous to rely on foreign-currency loans and the appropriateness of fiscal and monetary policies prior to the crisis. Since Western Europe's recovery and growth are likely to be slow, in the future East European countries will have to rely relatively more on internally-generated sources of productivity growth and enhanced global competitiveness.

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INTRODUCTION

While the focus of this essay is Eastern Europe (EE), it begins with a summary statement of the author's interpretation of the causes of the global crisis, and the remedies implemented and still needed in the USA and in Western Europe (Section 1). While some may find the summary useful in its own right, its main purpose is to serve as background for better understanding the developments and prospects in EE. As a further background, those essential broad commonalities as well as differences among the EE countries are elaborated that are particularly relevant for discussing the different impact of the crisis on the countries (Section 2). The following section examines the channels through which the global crisis has affected EE and what the countries have done to mitigate the impacts (Section 3). The last part suggests that the global crisis impels the EE countries to modify their growth strategies and it offers a set of recommendations (Section 4).

1. THREE GLOBAL CRISES: CAUSES AND REMEDIES

It is the author's contention that it is useful to view the global crisis of 2007–2009 as composed of three interdependent and mutually reinforcing crises: a *financial crisis* (financial institutions suddenly finding masses of non-performing assets on their balance sheets), a *liquidity crisis* (the sudden unavailability or dramatically higher cost of credits that previously were routinely granted, along with the seizing up of the market for certain kinds of financial assets), and a *crisis in the real economy*, that is, a substantial decline in output and a large increase in unemployment. For presentation purposes the causes and consequences of the three crises are discussed sequentially even though their timing overlaps. To be sure, these crises in the economic sphere have also been accompanied by social as well as ideological crises. Important as they are, their discussion is outside the scope of this essay.

The global financial crisis

It is the author's view that the fundamental causes of the global financial crisis can be traced to three sets of interrelated factors:

(1) *Persistent global imbalances in savings between Asia on the one hand, and North America and Europe on the other, reinforced by very low, at times even negative real rates of interest in the USA after 2000.*

Persistent global imbalances came about during this decade as China and other emerging economies in Asia grew at rapid rates and their societies saved an unusually high proportion of expanding incomes. Germany, Japan, and the Middle Eastern oil exporting countries were also high-saving economies. That several Western countries prohibited sovereign funds from some of the surplus countries to invest in real assets in the West also added to the savings glut. Contributing factors were the almost uninterrupted expansion in the world economy since 1992 and the accumulation of new wealth from natural resources, such as oil and raw materials. This led to an excess of intended global savings relative to intended global investment, causing dramatic declines in long-term interest rates. In the USA, this was reinforced by the low – at times negative – real rate of interest at which banks could borrow, thanks to the monetary policy of the Fed.¹

A good portion of the excess savings was mopped up by the developed West, as its “satisfaction now” culture prompted societies to consume more than they were producing. The major manifestation was the USA’s large and sustained current-account deficits. EE behaved likewise, its people and governments being impatient to converge to Western European living standards as their premature consumerism and generous welfare systems were not supported by corresponding levels of productivity.

At the same time, investor groups, accustomed to higher returns, were eagerly seeking them by purchasing financial assets whose higher risks were understood only after it was too late.

(2) The emergence of the so-called shadow banking system and the new types of financial instruments in the developed West whose dramatic growth was fuelled by incentives that made individuals and financial institutions rich while creating a huge, system-wide financial time bomb.

Shadow-bank like institutions, such as investment banks (ex: Bear Stearns and Lehman Brothers), hedge funds, structured investment vehicles (SIV), broker-dealers, private equity groups, and non-bank mortgage lenders grew at exponential rates during the past decade. Like commercial banks, they borrow short and lend long. They are subject to much lighter regulation than banks, and have operated with much greater leverage. Most importantly, most members of the shadow system did not have access to banking firewalls that prevent runs – deposit insurance and the central bank’s lender-of-last-resort liquidity.

¹ When the Internet bubble burst in late 2000, the Fed cut its policy rate from 6.5% to 3.5%. After the terrorist attack of September 11, 2001, the Fed continued to lower interest rates, all the way down to 1% by July 2002, the lowest rate for half a century, where it rested for a full year. For 31 consecutive months, the base inflation-adjusted short-term interest rate was negative (Soros 2008: xiv–xv).

As bond yields declined and stock yields followed, investors began to look for assets to generate the earlier higher real returns. The solution was “alternative investments”: real estate and securities tied to it, hedge funds, venture capital, private equity, derivatives, and commodity futures. The financial wizards (mostly in the shadow banking system) created obscure, unregulated financial instruments, packaged them and traded them, often with very high leverage of 30 or more to 1.² And traders were typically given bonus incentives to speculate, with huge personal financial gains if successful and modest personal risks if they failed, creating a widespread “moral hazard” in the financial system (Binder 2009).

(3) The developments stated under (1) and (2) were taking place while policymakers and regulators were dozing at the wheel.

For example, the US government sponsored the housing boom and regulators failed to stop the bubble. Interest rates were too low for too long, prompting excessive credit creation. The Basel international rules failed to impose appropriate capital requirements on securitised mortgage obligations held by banks and other financial institutions so they had build up gigantic portfolios, most of which turned into “toxic” assets when the bubble burst. US financial institutions were monitored by nine compartmentalised regulatory agencies, none concerned with overall systemic risks. Banking regulation in Europe was country-specific and uncoordinated, even though the most important financial institutions were regional or global in scope. And because neither in the US nor in the EU was there a “what if” plan for a financial crisis, early reactions to the crisis were haphazard and often inept.

* * *

The speculative new instruments, the high leverage, and the trading incentives did, for a time, generate large profits in the financial sector, but also one of the largest asset bubbles in financial history. The collapse of the subprime mortgage market beginning in August 2007 was the “spark”, the financial innovations the “channels”, of the contagion.

The essence of the *global financial crisis* was the sudden emergence of massive volumes of non-performing loans and other assets at banks and other financial institutions. This caused dramatic losses and declines in the equity value of these financial institutions, limiting their ability and willingness to make loans to the private sector, creating a credit crisis, which soon had multiple negative effects on the real economy.

² Leverage is the ratio of risk-weighted assets – mostly loans – to equity. For example, a ratio of 25 to 1 means that \$25 in loans is supported by \$1 in equity. The inverse is the so-called “Tier 1 common capital ratio,” expressed in percentage terms, which in this case would be 4%.

The global liquidity crisis

For the economy as a whole, *liquidity crisis* means two things occurring simultaneously. One, certain financial assets become extraordinarily difficult to trade, as buyers disappear, i.e., *market liquidity* dries up. Two, the lenders severely reduce the number of loans they make or stop giving loans altogether, i.e. *funding liquidity* disappears or its cost rises dramatically (Brunnermeier – Pederson 2008). Because so many banks rely on the interbank loan market to borrow short term when needed, and companies rely on both types of loans to meet their short-term obligations, dramatically reduced lending in these markets has a ripple effect throughout the economy, causing liquidity crises at a plethora of individual companies, which in turn affects individuals and the real economy.

The global financial crisis, with a score of venerable global financial institutions facing massive volumes of non-performing loans and other assets, automatically impaired liquidity in the financial system. However, the problem was hugely exacerbated in September 2008 with the inept decision, made jointly by the US Treasury and the Federal Reserve, to suddenly and unexpectedly let Lehman Brothers – a large and systemically important investment bank – go bankrupt, soon after the government came to the rescue of investment bank Bear Stearns and also to the world's largest insurance company, AIG. The tragedy of letting Lehman go was that huge losses were suffered not only by the owners and investors in Lehman but also by the thousands of customers of Lehman, whose routine financial transactions with Lehman were not honoured.

The decision to let Lehman go bankrupt at a time when financial institutions throughout the world were reeling from the effects of the financial crisis created such uncertainty about credit risks that private credit markets froze; no one wanted to invest in or lend to banks, or to each other, in the crisis situation. Thus, Lehman's collapse triggered a severe global *liquidity crisis*, exacerbating the big problem borrowers worldwide had been facing since August 2007.

The global economic crisis

In such a situation, banks and other financial institutions practically stopped lending to the private sector, even though credit is the lifeblood of the real economy. To the extent that lending continued, the criteria became more stringent and the costs significantly higher. This is one channel through which the contagion spread from global finance to the global real economy. Another channel was the immense loss of wealth that the private sector suffered as stock markets crashed, pension funds bled, and housing prices slumped. The combination of impaired

credit and loss of wealth caused consumption and investment to plummet, GDP to decline and unemployment rates to rise, generating the global *economic crisis*. As consumption and investment declines, their negative impacts spread through the well-known multiplier effects.

The three crises – financial, liquidity, and economic – reinforced each other, causing the most severe economic dislocation in the world in the past six decades.

Remedies introduced

The worst economic crash since the Great Depression required governments urgently to act on three fronts simultaneously: to undertake massive *additional fiscal spending* until the private sector recovered, to greatly *ease monetary policy*, and *to restore the health of the financial sector*.

Additional fiscal spending is relatively easy, at least for countries that are large and stable enough to finance the resulting deficits with government borrowing, as well as for those smaller countries whose governments have not impaired their credit-worthiness through sustained profligate spending during boom times. In a major economic downturn, stimulus via deficits to create demand and jobs has had broad public support. Economists realise, however, that the immense expansion of deficits and debt/GDP ratios during 2008–2010 will have to be reversed. This implies budget cuts and tax increases, which will constrain future economic growth.

Easing monetary policy by the central banks means, first and foremost, reducing their policy rates (the interest rate they charge to banks and other prime borrowers that are given access to a central bank's "discount window") in order to encourage lending. Again, monetary policy can be *responsibly eased* only by countries that do not face strong inflationary pressures or the problem of financing their external debts. When interest rates have already been lowered to near 0% and fail to produce the desired effect, central banks may also resort to "quantitative easing": purchasing from financial institutions assets (mostly short-term, such as government paper and corporate bonds), hoping that the additions to the money supply they are so creating *ex nihilo* (out of nothing) through deposit multiplication will encourage bank lending, thus stimulating the economy. Even this is far from effective as banks use a large part of the inexpensive funds from their central banks to replenish their capital; the rest to lend to credit-worthy borrowers at high rates, generating good profit margins.

Restoring the health of the financial sector is also urgent; implementing it is difficult. The key lesson of the 122 individual country banking crises experienced

since World War II is that neither fiscal stimulus nor a substantial easing of monetary policy, alone or in combination, will restart sustainable growth without the authorities also restoring the health of the financial sector.³ That, in turn, also requires institutional credibility on the part of the authorities as well as the financial institutions themselves. Banks generally remain reluctant to make new loans as long as they have large volumes of (often not fully disclosed) non-performing loans on their books.

Restoring the health of financial institutions by spending huge sums of taxpayer money buying impaired (“toxic”) assets and recapitalising the banks – perceived as the main culprits of the crisis – is controversial and thus politically difficult. The logic of why it is essential to bail out banks and other financial institutions is less evident to the public, so legislators are balking at appropriating the huge sums needed. These are the reasons why many governments are not acting promptly or fully, and those that do are designing schemes that have questionable aspects.⁴ Wherever possible, the authorities are pressuring the private sector to recapitalise the banks, with some degree of success in several countries.

Improving financial regulation is also of high priority; progress is slowly being made. There is pretty much a global consensus that bank capital requirements will have to be increased and calibrated to the business cycle (higher requirements during boom times than during recessions); also, that financial institutions that are “too big to fail” should have higher capital requirements and be charged for the implicit social insurance. There is agreement, too, that the shadow banking sector must be regulated more closely.

The many regulatory issues still being debated include the desirability and feasibility of separating commercial banking from investment banking activities; also, how to prevent the abuse of the so-called credit default swap (CDS) instrument (discussed below). Another key issue to be resolved is whether regulation can be effective as long as it remains national even though many financial institutions are multinational.

³ The best known recent example is Japan’s decade-long stagnation in the 1990s, until the government cleaned up the banking system.

⁴ One example is the US’s “public/private partnership investment program” under which the Treasury will use \$100 billion taxpayer money to leverage private money to purchase toxic assets, with the government bearing most of the risks and private investors getting potentially large rewards. Another is Germany’s proposed “bad bank” plan, aimed at “protecting the taxpayer”, which the *Financial Times* says “it does not look as though it will work.” (May 12, 2009).

2. EASTERN EUROPE: COMMONALITIES AND DIFFERENCES

The focus of this essay is on the ten former Communist countries that are now members of the EU. However, in some instances some of the other former communist countries are included, too. Such comparisons illustrate similarities and differences between the EU ten and others in the region.

Commonalities

Growth strategies

The most significant common feature of the EE countries has been their *growth strategy*. Until the fall of 2008 it was conventional wisdom – and widespread practice – that the most appropriate sustainable growth (and catching-up) strategy for the small, open economies of EE is a rapid increase in their exports and investment, actively supported by sustained net capital inflows. This growth model and the implied catching-up process involved persistent current-account deficits (*Figure 1*). This meant, by definition, negative national savings. Until the fall of 2008 the deficits were enthusiastically financed by the rest of the world. EE obtained capital through large net inflows of foreign direct investment (FDI), portfolio investment, private and official borrowing from the abundantly liquid global credit markets, from regional and international financial institutions, and in the form of Western, mainly EU, aid.

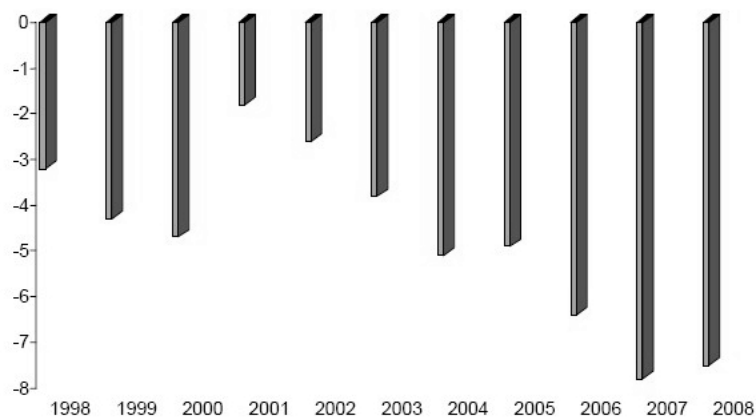


Figure 1. Current-account deficit of the ten EE countries, 1998–2008
(as percent of GDP)

Source: IMF, as compiled by Surányi (2009).

Global integration

An integral part of this growth strategy was EE's growing integration into the global economy. Integration between Western and Eastern Europe meant that a region with relatively scarce capital and an abundance of inexpensive and skilled labour became integrated with a region with abundant capital and expensive labour. Therefore, it made economic sense to have large net capital flows from West to East. This caused productivity in the East to rise faster. However, in several countries, including Hungary, wage increases during the decade's boom years exceeded substantially gains in productivity, leading to a rapid and eventually unsustainable growth in consumption.

A particularly significant channel for capital inflows, as well as an example of EE's integration with Western Europe, was the region's banking sector. In the EE countries, the *banking sectors are largely owned by foreign parents*, primarily from Western Europe. At the end of 2006, the asset share of foreign-owned banks in 14 of the 18 EE countries shown in *Figure 2* were above two-thirds in the respective countries' total banking assets; in several EE countries the shares approached 100%. Among the ten EE members of the EU, only in Slovenia was the share of foreign-owned banks about 30%.⁵ (In Ukraine, the share was close to 40%; in Russia, about 10%.)

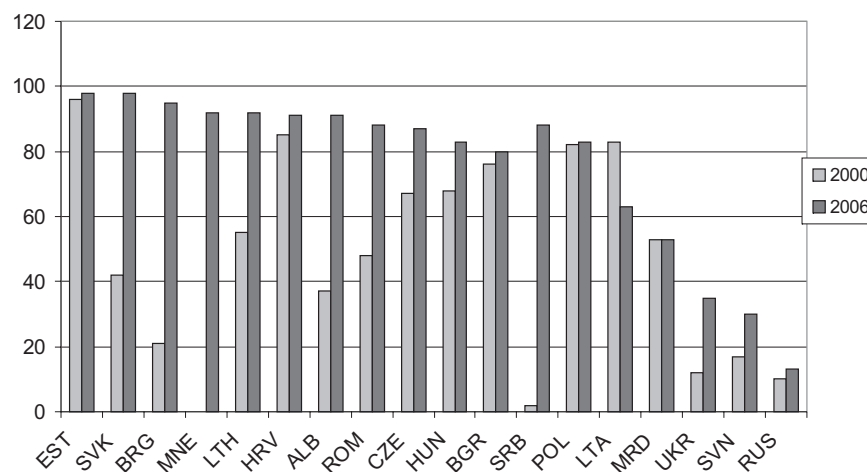


Figure 2. Asset share of foreign-owned banks, 2000–2006

Source: Árvai et al. (2009: 6).

⁵ As of the end of 2008, in terms of market shares (total assets), the government-controlled banks, foreign banks, and domestic private banks accounted for 48%, 30%, and 22%, respectively (IMF 2009b: 12).

Foreign ownership of EE's banking systems has brought major benefits to the host countries, such as modern banking (e.g. advanced technology, risk management techniques, and increased financial intermediation) and, most importantly, access to cross-border funding. Foreign banks have been important channels for capital inflows when local banks were bought or established, and then as the parents invested in or loaned additional funds to the subsidiaries for relending to the local private sector. The resulting credit booms had contributed to the rapid growth of incomes in EE, thereby facilitating the convergence process. The rapid growth of credit generated large profits for the parents through 2007, but also vulnerabilities since 2008, an issue to which we will return.

Another commonality is that during the past decade, the majority of the ten EE countries have by and large followed responsible fiscal policies. Hungary and Latvia were the main exceptions. Hungary's budget deficits as percent of GDP were higher during most of the boom years of 2001–2007 than those of the other countries in the region. By 2007, Hungary's public debt as percent of GDP rose to 66%; by early 2009 it reached about 75%. In 2007, Hungary's consolidated public debt (according to the standard Maastricht criterion) was the highest in EE and one of the highest in the EU (IMF 2009a). This reflects its politicians' refusal during the past decade (since 1998) to continue with needed reforms, such as in the welfare, pension, health, education, and tax systems. (Hungary was the region's leading reformer before 1998.) Partly as a consequence of this standstill, the share of government expenditures in GDP is much higher in Hungary's "premature welfare state" than the country's level of development would warrant: 50% versus in the low 40s in the Czech Republic, Poland, and Slovenia, and considerably lower still in the rest of EE. One problem in Hungary is that 43% of the working-age population is officially "inactive", receiving payments from the budget without contributing to its revenues.

Differences

Space limitations allow us only to highlight two differences among the EE countries: their choice of exchange rate regimes, with particular attention to the timing of euro's adoption, and the extent of foreign-currency borrowing.

Exchange rate regimes

Exchange rate regime refers to the rules that establish how a country's exchange rates are determined, their degree of flexibility, and whether there is a formal or informal official commitment to an exchange rate path.

As long as a country has its own currency, the exchange rate is one of the main channels through which external events, such as the global crisis, are transmitted to the domestic economy. A country's exchange rate regime and policies are also key determinants of its monetary policy, hence of its ability to respond to the global crisis.

Upon joining the EU, the ten EE countries had to agree to adopt the euro at some point. Adopting the euro means that from that point on the country no longer has an independent exchange rate regime or policy, or independent monetary policy, for that matter. Thus, the issues of exchange regime and euro adoption are related.

As of November 2009, the ten EE countries had one of the following three types of exchange rate arrangements: 1) having adopted the euro; 2) the exchange rate was pegged to the euro under a so-called "currency board" arrangement; or 3) the rate was largely market determined, that is, "floating". In some countries, for example in Romania, the exchange rate is "managed" by the monetary authorities, an arrangement called "managed floating". In the other three countries the currencies are independently floating, which does not exclude the possibility of exchange rate intervention by the authorities, for example, to smooth fluctuations.

Euro adopted: Slovenia (2007), Slovakia (2009)

Currency board: Bulgaria, Estonia, Latvia, Lithuania

Floating: Czech Republic, Hungary, Poland, Romania

Most of the rest of the countries in the region – Russia, Ukraine, the other countries of Central Europe, the West Balkans, the Caucasus, and Central Asia – have various kinds of "managed floating" exchange rate regimes.

1) *Euro adoption.* Adopting the euro has unquestioned benefits for members, including the stability associated with one of the world's leading currencies, lower interest rates and easier access to funds, no currency transaction costs with other Euro countries, and greater pricing transparency and thus competition. The perceived benefits for the weaker countries have increased greatly during the current crisis because those with the euro do not have to worry about the large costs of currency fluctuations. Membership also provides "cover", for example, access to European Central Bank (ECB) credits.

Adopting the euro also has costs. Most important: the country automatically loses a key instrument of monetary policy, exchange rate adjustment (for example, to devalue to improve competitiveness or to revalue to keep inflation in check). Loss of the exchange rate adjustment tool can be especially painful if the currencies of key competitors do depreciate – as had happened early in 2009 – causing loss of competitiveness for the country that has adopted the euro or

pegged its currency to the euro. Each time a competing economic partner joins Euroland, the intensity of this problem is reduced for those already in the euro system. Therefore, the cost-benefit calculations of joining the euro are influenced by the euro decisions of the competitor countries.

The “optimum currency area” theory states the conditions under which it is advisable for a country to join and give up its currency and thus also its shock-managing tools, i.e., independent exchange rate and monetary policies. According to the theory, it makes sense to do join if (a) the type and intensity of expected external shocks, (b) the nature of its business cycles, and (c) the structure of its economy and foreign trade are similar to those of the other members of the monetary union. These conditions are by and large met by the ten EE countries, although there are areas of concern, such as labour market and other rigidities.

Perhaps the greatest difficulty of euro adoption is the narrow road that a country must travel for several years from the time its euro candidacy is accepted (by the EU and the ECB) until it crosses the euro-gate. Euro eligibility conditions are specified in the so-called Maastricht criteria: government budget deficit of not more than 3% of GDP, a public debt level of less than 60% of GDP, an inflation rate that is within 1.5% of the three best-performing members, and long-term interest rates that are within 2% of the three best anti-inflation performers. These objectives are difficult to achieve, and sustain, *simultaneously*. And prior to Euro-zone entry, a country must spend two years in the so-called exchange rate mechanism (ERM-2), during which the currency is expected to remain within 15% of either side of its announced central rate *vis-à-vis* the Euro. In case market pressures force the currency to go outside its band, the country’s central bank and the ECB may intervene to maintain the band. In exceptional cases the central rate can be changed.

Although one may argue that the Maastricht criteria are too mechanical to fit the circumstances of each and every country, one counter-argument is that the criteria represent a sound roadmap toward responsible economic policies. And should the criteria be subject to country-specific adjustments that would not be fair to existing members and would open the door to interminable bargaining by the candidate countries.

In each of the ten eligible EE countries there has been an intense debate among experts and policymakers about when the country could and should start, and how rapidly it should proceed, with convergence (that is, pursuing policies designed to achieve the Maastricht criteria simultaneously), and what central rate should be set *vis-à-vis* the Euro when the time came.⁶

⁶ One issue is the likelihood that the central rate can be defended for two years in the face of foreseen or unforeseen economic, financial, and political developments. Furthermore, if the

Slovenia was the first in the region to adopt the euro, in 2007. Aided by broadly favourable initial conditions and generally sound macroeconomic policies, Slovenia had achieved an impressive growth rate for a sustained period, with small external imbalances, while gradually lowering inflation to euro-zone levels. Following the euro's adoption, inflation accelerated during 2007–2008 (insufficient retail competition, cost-push and demand-pull being the main causes, the euro's introduction a minor cause), which then moderated in 2009 (IMF 2009b).

A much more serious problem is that structural rigidities have remained, notably, an inflexible budget; much too generous welfare, unemployment, and pension systems that discourage labour participation; an inflexible labour market; and a restrictive business environment. These rigidities have contributed to standardised FDI inflows having been low relative to most other EE countries.

The loss of the exchange rate instrument puts a premium on softening structural rigidities to maintain external competitiveness. The lesson for the other EE countries is that maintaining or enhancing competitiveness requires the authorities to pursue with equal fervour prudent macroeconomic policies as well as structural reforms in the economy.

Slovakia has adopted the euro in 2009. It distinguished itself by pursuing beforehand prudent macroeconomic policies *and* undertaking far-reaching structural reforms, too, for example, in its welfare, pension, and tax systems. As a consequence, it benefited from large FDI inflows, especially in the export-oriented car and electronic industries, and achieved impressive growth rates for several years. During its 2006–2008 stay in ERM-2 its currency's central parity against the euro had been revalued twice, by nearly 30%. This reflected Slovakia's good economic performance as well as of the desire of its authorities to make people and businesses feel relatively "wealthy" upon joining Euroland. Of course, this also had costs, such as a decline in Slovakia's export competitiveness.

2) *Currency Board* means an explicit legislative commitment to exchange local currency for a specified foreign currency at a fixed exchange rate. This arrangement also means that domestic currency will be issued only against foreign exchange in the possession of the authorities, so that the currency remains fully backed by foreign assets. Further, a currency board arrangement means the elimination of such traditional central banking functions as monetary control and serving as a lender of last resort to domestic financial institutions. Thus, there is little scope for discretionary monetary policy, as in the countries that have joined a monetary union.

central rate is established when the local currency is weak, then all local-currency financial instruments will be worth less in euros than if the central rate were set when the local currency was stronger.

The three *Baltic countries* had made strong commitments years ago to adopt the euro as soon as possible. Partly for this reason, they all pegged their currencies to the euro, under currency board arrangements.⁷ *Bulgaria* did likewise. None have qualified so far. In 2006 Lithuania missed only the inflation criterion – and that only by 0.1% point – and was refused to enter.

These countries have economic, historical, and political reasons for straining to introduce the euro and, until then, to adopt the next closest arrangement to it. Having suffered hyperinflation is the historical experience that pushes them to desire one of the world's most prestigious currencies. Tying their countries to the West even more strongly is the political reason, especially in the case of the Baltic nations.

3) *Floating*. The monetary authority attempts to influence the exchange rate without having a specific exchange rate path or target, although it may set a band within which the exchange rate is allowed to be determined by market forces. Indicators of managing the exchange rate are broadly judgmental, for example, international reserves, inflation targets, and the movement of relevant other exchange rates. Intervention may be direct (buying and selling the domestic currency against foreign currencies) or indirect (for example, changing the policy rate).

Foreign-currency indebtedness

A natural consequence of EE's growth model – resting on the rapid expansion of exports and investment and sustained current-account deficits financed by large capital inflows – is that the debt portion of foreign financing (of the country's net negative savings) will generate uncovered foreign-currency positions.

There are two key questions in regard to foreign-currency indebtedness. First, are the cumulative current-account deficit and the companion foreign-currency debts too large to be sustainable? Second, what combination of sectors is burdened by the nation's foreign-currency debt: the state, the enterprise, or the household sector, and are special vulnerabilities created by the sector composition of the debt?

Until the third quarter of 2008, the consensus answer to the first question, for the region as a whole, was “no” since external financing of the current-account

⁷ A currency board combines three elements: an exchange rate that is fixed to an “anchor currency”, automatic convertibility (that is, the right to exchange domestic currency at this fixed rate whenever desired), and a long-term commitment to the system, which is often set out directly in the central bank law. The main reason for countries to contemplate a currency board is to pursue a visible and effective anti-inflationary policy.

deficits was readily available for those EU member EE countries that needed it. In the last quarter of 2008 in many countries the answer changed to a “yes”, as discussed in Section 3.

Among the EE countries with very large external debts (Latvia, Estonia, Bulgaria, and Hungary), all but Hungary had very small *public debts*, so their public sectors must not have faced serious problems of external financing. Through September 2008, Hungary, with a large external public debt, had no difficulty with continued access to foreign financing. Suddenly it did; the story is detailed in Section 3.

Everywhere, the *enterprise sector* can be assumed to be able to manage its foreign-currency indebtedness because exports are usually billed in euros and either the local currency is pegged to it (in the Baltic States and in Bulgaria) or the firms are supposedly sophisticated enough to manage the exchange rate risks (Czech Republic, Hungary, Romania, Poland).

The main concern has been the rapid accumulation of foreign-currency borrowing by *households* in Hungary. The worry was that a substantial and lasting depreciation of the local currency would impose huge financial costs on the borrowers. Some (or many) would then have no choice but to default on their mortgages, as did the “subprime” borrowers in the USA and elsewhere. And the banks that made the loans, mainly the local subsidiaries of Western European banks, could suffer massively as a consequence.

To analyse the situation objectively, it is useful to examine whether the massive foreign-currency indebtedness of households in certain countries was based on rational considerations or whether the debtors were ignorant of the risks and the banks exploited this in an irresponsible way.

I identify with the view which holds that neither were most borrowers irrational nor most lenders irresponsible, apart from some extreme cases. Borrowing in foreign currency was a rational choice by the private sector in the new EU countries as long as convergence toward the Euro-zone was a reasonable expectation.

Some have argued that it was short-sighted of lenders and borrowers alike to assume that convergence will be continuous, that there would not be periods of currency depreciation and recession, during which the payment burdens would rise and therefore some (many) borrowers would not be able to afford the monthly payments. This of course is true even if over the lifetime of a 15- to 20-year mortgage the borrower would be much better off with a foreign-currency than with a local-currency mortgage. Be that as it may, neither the borrowers nor the lenders were prepared for the problems that such developments did cause when the global financial and liquidity crises hit EE. This is understandable; after all, who plans his finances by assuming a global crisis, which even experts did not foresee. The banks, which were expanding rapidly in the region, were accommodating in offer-

ing foreign-currency loans because they could readily obtain inexpensive such loans (often from their Western European parents) and the loans they were making (in some cases, pushing) were highly profitable.

In all EE countries, especially in those experiencing real estate bubbles (e.g., the Baltic countries, Romania, Ukraine) there were borrowers who speculated and assumed way too much debt, in whatever currency, becoming overextended. But this was the problem of excessive credit, not foreign-currency borrowing per se.

What factors, in addition to sustained external deficits at the macro level, played a role in the rapid expansion of household foreign-currency debt in certain EE countries?

1. When a central bank in EE raises the policy rate – which it might do for several reasons (i.e., to offset expansionary fiscal policy, to help bring inflation under control, or to make it more attractive for foreigners to purchase government debt, or some combination of these), it will widen interest rate differentials in favour of domestic over foreign assets of the similar type. This will stimulate locals to take out lower-cost foreign currency loans, which will fuel the very consumption and other spending that the central bank intended to constrain by its “tight” monetary policy.

2. During the current decade, especially between 2002 and 2008, the EE currencies on managed floating regimes have appreciated significantly in nominal terms and to some extent also in real terms. Economic theory predicts such a long-term trend for developing countries where productivity is growing faster than in the countries with which they are catching up. Appreciating exchange rate is also the main instrument for reducing inflation, which has to be a priority objective of countries that aspire to adopt the euro. Thus, while exchange rate depreciation was viewed (in countries with floating exchange rates) as a definite possibility in the short run, the much more probable bet for the long run was continued currency appreciation. And since most foreign-currency loans represent 10- to 25-year mortgages, the rational expectation of the borrowing households was that foreign-currency over domestic-currency loans would be doubly advantageous since interest rates were lower and the local currency would most likely appreciate over the period of the mortgage.

3. In EE’s still somewhat volatile economic and political environment, fixed-interest-rate mortgages simply do not exist; only adjustable-interest-rate mortgages are offered. Therefore, exchange-rate volatility and risk are the mirror images of interest-rate volatility and risk. Thus, whoever is concerned about the exchange-rate risks of foreign-currency mortgages should also be aware of the interest-rate risks of domestic-currency mortgages (Surányi 2009).

Figure 3 charts the share of foreign-currency loans in the household loan portfolios of nine EE countries in 2003 and in 2008. (For Slovenia, which adopted the euro in 2007, this is no longer a relevant statistic.) There are dramatic differences among the countries in the level as well as in the rate of growth of the shares of foreign currency loans. In 2008 the shares were close to 90% in Latvia and Estonia; about 70% in Hungary; about 60% in Lithuania and Romania; about 40% in Poland; around 30% in Bulgaria; and close to zero in Slovakia and the Czech Republic.

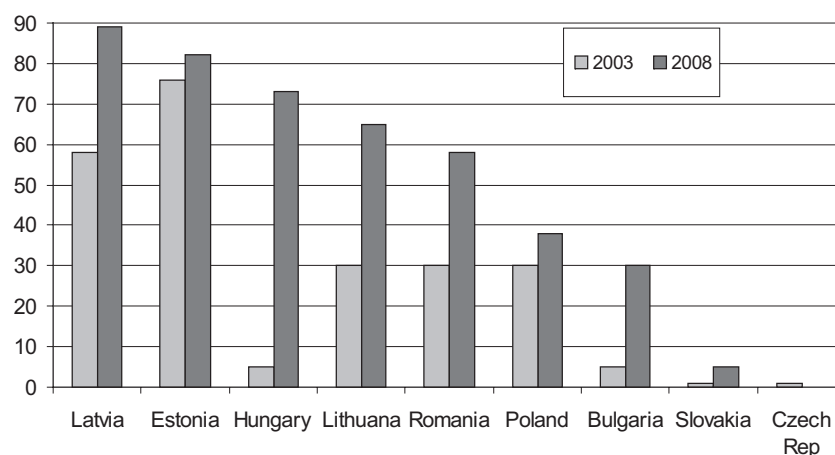


Figure 3. Share of foreign-currency loans in household loans in selected East European countries in 2003 and 2008

Source: IMF, as compiled by Surányi (2009).

The shares were high or relatively high in countries with large interest-rate differentials (foreign-currency loans were cheaper): Hungary, Romania, and Poland; and in countries with fixed exchange rates: the Baltic States and Bulgaria, where there did not *appear to be* any exchange rate risk. In Hungary, the large jump between 2003 and 2008 was also due to the region's fastest growth in real incomes between 2000 and 2006. With regard to Slovakia and the Czech Republic, one may speculate that since the latter countries had pursued prudent fiscal policies so their governments did not accumulate large public debt, domestic interest rates and thus the interest-rate differences between local and foreign currency loans were much lower than in the other countries, so there was much less incentive to borrow in foreign currency. Also, the Czechs have traditionally been financially more conservative than their neighbours. It is interesting to note that the shares of foreign-currency loans in household loans are not related to the countries' exchange rate regimes.

3. IMPACTS OF THE GLOBAL CRISES IN EASTERN EUROPE

This section examines the impact of the three interlinked global crises in EE. Interwoven into the story is a discussion of Western perceptions and misperceptions about how the crises would or did affect EE.

The global liquidity crises

During the second half of 2007 and until the collapse of Lehman Brothers in mid-September 2008, conventional wisdom, generously sprinkled with hope, was that Continental Western Europe – and perhaps EE, too – would be bypassed by the financial storms, on the grounds that Continental Europe's financial operations were more conservative and better regulated than those of the USA, and that EE's financial system was closely tied to Western Europe's.

The global liquidity crisis, triggered by the September 2008 collapse of Lehman, hit EE's most vulnerable economies (Hungary, Bulgaria, Romania, and the Baltic States) immediately and hard, while the region's less vulnerable countries (Slovenia, Slovakia, the Czech Republic, and Poland) were less affected.

The impacts on the most vulnerable countries can be summarised as follows. First, credit facilities that were previously granted – routinely and at a reasonable cost – to EE governments, banks, and the rest of the private sector were simply closed off. Independently, FDI inflows also plummeted. Then, to the extent that the credit spigot was opened a little for some borrowers (governments and large banks), the cost of credit skyrocketed. These quickly had large negative impacts on the real economy, with multiplier effects.

Shortly after the global liquidity crisis hit, the exchange rates of the floating EE currencies plummeted, heightening concerns about the serviceability of foreign-currency loans in those EE countries where such loans were substantial. The unavailability of credit and the region's plunging exchange rates then put immense pressure on the EE countries with large external public debts (e.g. Hungary) or pegged exchange rates and large private external debts (the Baltic states and Bulgaria): will their governments have sufficient foreign exchange and credibility to refinance their debts and/or to maintain the peg as foreign credits became unavailable and the countries' export earnings declined?

Let's illustrate this sequence of events and their consequences with two case studies: Hungary's dramatic steps in October 2008 to sell government securities on international capital markets and Latvia's desperate attempt to maintain the fixed exchange rate in the face of seemingly impossible odds.

Hungary's sovereign debt and international investors

As a consequence of the liquidity crisis, early in October 2008 foreign investors sold more than \$2 billion of Hungarian government securities. At the end of 2007 Hungary's gross foreign-currency indebtedness was 100 billion Euros (about \$135 billion). Of this, 34 billion Euros (about \$45 billion) were owed by central and local governments; 66 billion Euros (\$89 billion) by banks (mainly), corporations, and households (Narancs 2009). Thus, within a matter of days, 5% of Hungary's foreign-owned securities were dumped. More importantly, there were simply no takers on the international capital markets of Hungary's newly issued and attractively-priced bonds. Relative to GDP, Hungary's sovereign debt is the largest in EE, so obtaining external financing or refinancing was critically important.

In the meantime, after years of appreciation, in October 2008 the Hungarian forint (HUF) depreciated from 240 to 280 per euro, that is, by 17%.

The Monetary Council of Hungary's central bank met on Monday afternoon, October 20th and kept the policy rate unchanged at 8.5%. On the morning of October 22nd the Council met in emergency session and jumped the policy rate by an almost unheard of 3%, to 11.5%, even though the medium-term inflation forecast remained unchanged at 3% per annum. The dual purpose of the action was to halt the decline in the exchange rate and to create external demand for Hungary's sovereign debt.

The global liquidity and financial crises reduced dramatically the risk appetites of investors. To the sovereign debts of countries that previous to the crises investors judged to be hardly risky at all, suddenly large *panic risk premiums* were attached. Such premiums are quantified in the so-called *credit default swap (CDS)* rates. The annual cost (premiums) on CDS is expressed in 'basis points': 100 basis points = 1%. For example, during 2005–2007, Hungary's 5-year sovereign credit risk spread had remained consistently below 50 basis points, that is, under 0.5% (Varga 2009). (We may look at the regularly paid premium as a portion of the nominal interest paid by the reference entity to the party holding the bond instrument, which the latter may pass on to the protection seller in exchange for the seller's assumption of the credit risk associated with the issuer.)

In any case, country CDS rate differences do reflect the market's judgment about a country's fiscal and/or monetary policies, as well as special circumstances. For example, Hungary's and Romania's fiscal policies were judged to be less prudent, so on October 24, 2008, their country panic risk premiums rose to about 600 basis points (6%). Latvia's sovereign CDS rate jumped the most, to 1200 basis points, or 12%, owing to the worry about its ability to maintain its increasingly overvalued pegged exchange rate. And since the economic policies

and prospects of the Czech Republic and Poland were considered to be much better, their CDS premiums rose much less.

The government of a country facing a relatively high CDS rate (which quantifies risk perceptions, reflecting global risk appetite as well as economic and political concerns about the country) must offer a sufficiently high interest rate on its bonds to compensate prospective foreign purchasers for the high cost of sovereign credit insurance. This is why we saw a jump to 11.5% in Hungary's policy rate in October 2008.

Between October 2008 and March 2009, Hungary's sovereign CDS rate fluctuated between 4% and 6%, so let's take the average of 5% for an illustration. During this period Hungary issued shorter- and longer-term bonds at 11.5%. Prospective *foreign purchasers* of Hungarian bonds had to reckon three types of risk: Hungary's inflation rate, the risk of default by Hungary's government, and the HUF/euro exchange rate risk between the time they invest and when they will reconvert.

Medium- and longer-term inflation in Hungary was officially projected at around 3% per annum. Default insurance on Hungarian bonds was 5% per annum (the 500 basis point CDS rate). So the 3.5% that remained ($11.5 - 3 - 5$) had to cover the real rate of interest (very low at the time in the West on account of the extremely easy monetary policies of the central banks) and the HUF/euro exchange rate risk.

With Hungarian government bonds (which bear no exchange rate risk and very small default risk for domestic investors) paying 11.5%, banks in Hungary had to pay at least comparable rates for time deposits. Given the risks and costs involved in lending, it is not surprising that even prime businesses were charged, *for local-currency loans*, about 15%, mortgage holders about 20%, and unsecured consumer loans about 30%. These high rates were a serious drag on the economy. They also stimulated the rapid growth of foreign-currency loans, which made economic sense under the circumstances.

This case study illustrates how a combination of the global financial and liquidity crises and Hungary's imprudent economic policies (i.e. uncontrollable external and controllable domestic factors both being reflected in Hungary's high sovereign CDS rate) had a large negative impact on Hungary's economy. Luckily, as the liquidity crisis abated and as the interim government of Prime Minister Gordon Bajnai successfully tackled a number of fundamental problems (since April 2009), by early November 2009 Hungary's sovereign CDS rates declined to 200 basis points (2%), approaching the CDS levels of the Czech Republic and Poland. Hungary could also cut the policy rate, in sequential steps, from 11.5% in October 2008 to 6.5% in November 2009.

One lesson for those EE countries that have not yet adopted the euro is that policymakers have a responsibility to make sure that domestic interest rates are not greatly in excess of euro interest rates. This requires responsible fiscal and monetary policies so that relatively high inflation as well as interest rates (two of the Maastricht criteria) would be brought down. Policymakers also have a duty to impose prudential lending guidelines, especially during boom times, to prevent private debts reaching unsustainable levels and hold down asset price inflation. Such policies, in turn, will reduce country credit risks (reflected in the CDS rate), supporting a virtuous circle, bringing closer the time when an EE country can join the monetary union, eliminating the foreign-currency problem.

Latvia's fight to maintain the currency peg

After a period of impressive growth, by 2008 all three Baltic countries were facing severe difficulties, for similar reasons. The most extreme case was Latvia. Following acceptance into the EU in 2004, it experienced a huge boom, with GDP growth rates above 10%. But all this time large imbalances were building: an unsustainable tempo of credit growth; a large build-up of *private external debt* amounting to about 130% of GDP; and a current-account deficit peaking at nearly 25% of GDP in 2007, one of the largest in EE, in fact, in all of Europe.

Latvia's high inflation during the boom years was caused in part by its outmoded structure of production. And its firmly fixed exchange rate also helps to drive up costs, making the country less competitive. With higher productivity growth than in most Western European countries, the exchange rate should have appreciated in real terms (as in the floating-currency countries), which would have helped to tame inflation. But the currency could not appreciate on account of the peg. A further cause of Latvia's loss of competitiveness was that much of the capital inflows that spurred economic growth went into the non-tradable sectors, such as real estate, retail, and financial services, where compensation grew rapidly, driving up wages in all sectors, without corresponding improvements in productivity.

When the currencies of Hungary, Poland, the Czech Republic, Romania, Ukraine, and some others in the region collapsed in late 2008 and early 2009, the pressure on Latvia's *lat* and the other Baltic currencies intensified, in expectation that sooner or later these countries would have neither the political will nor the financial means (reserves) to defend their fixed exchange rates.

In December 2008 the IMF, the World Bank, the EU, and the Nordic countries agreed to a \$10.5 billion bailout loan to support Latvia's adjustment policies, focusing on fiscal tightening to cut inflation and thus to be able to maintain the peg.

(The EU's share was the largest, \$4.3 billion; the IMF's \$2.4 billion.) One condition of starting to disburse the instalment was that the 2009 budget deficit would not go above 5%.

Although we are getting ahead of the story, let us note that in 2009 the economy continued to plunge much more than was foreseen in the December program. The May 2009 forecast (confirmed in September) was an 18% GDP decline in 2009, the largest in Europe. The government fell.

The loss of tax revenue on account of what can only be called a depression has initially raised the estimated budget deficit for 2009 to 9% of GDP, then into double digits, much higher than agreed to with the prospective creditors when the rescue package was negotiated. The new government's continuing challenge has been how to deal with the dramatic revenue losses, requiring continuous budget cuts to remain at a level consistent with the country's strategy of maintaining the peg to the euro. That is, it must meet the budget conditions of the rescue package to receive the funds Latvia needs to defend the peg. The government has been cutting down state wages and prodding companies to do the same. Policymakers are betting that the resulting plunge in consumer demand will curb inflation, bringing it in line with the Euro countries, whose currency Latvia is trying to join. Thus, Latvia's strategy is *internal devaluation*, not currency devaluation (Bloomberg 2009).

Why such determination in Latvia (and in the other Baltic countries and Bulgaria) to maintain the peg to the euro? One reason is that devaluing the currency would also be associated with huge economic costs because the businesses and households that borrowed so much – largely in foreign currencies but with their incomes in the local currency – would suddenly have much heavier debt-service burdens. And if one Baltic country devalues, the other two is unlikely to have any option but to follow. But it goes beyond that, though. The peg has been a symbol of Latvia's (and the other Baltic countries') stability and independence, and has been in place almost since the countries won independence in 1991. Maintaining the peg is the quickest way to euro adoption within the foreseeable future which the authorities plan firmly by 2014. This justifies, in their eyes, the current sacrifices.

The global financial crises

Returning to the chronology of the impact of the global crises on EE, the first half of 2009 saw the issue of Western European banks' "dangerous exposure" to EE grabbing world headlines. The articles explaining the headlines claimed that not only do the banking systems in Western Europe face fundamental problems, but

that a (if not the) main source of their difficulties was their heavy exposures in EE. (Recall from *Figure 2* that the subsidiaries of Western European banks dominate the banking sectors in EE.) A particularly serious concern voiced in the Western press was the vulnerability of the subsidiaries in EE on account of having extended so many foreign-currency loans; in the Eastern press, that the parents, facing difficulties at home, would drastically reduce their Eastern exposures or withdraw altogether, triggering a financial crisis in the region.

To analyse the impact of the global financial crisis in EE, let us address two key issues: the nature and extent of Western financial exposure in EE and the fear that parents in Western Europe might withdraw massively from EE.

Foreign-currency mortgages: two interpretations

In early 2009, after the collapse of Lehman, the *Financial Times* and other leading Western media warned that Western Europe's banking exposure in EE was analogous to the subprime loan crisis in the USA, owing mainly to the large volume of foreign-currency mortgages and consumer loans granted (*The Market* 2009). The implication was that they will cause comparably large losses in EE and for their Western parents. Austria was shown to be the most vulnerable, followed by Belgium, Sweden, and The Netherlands (*Figure 4*).

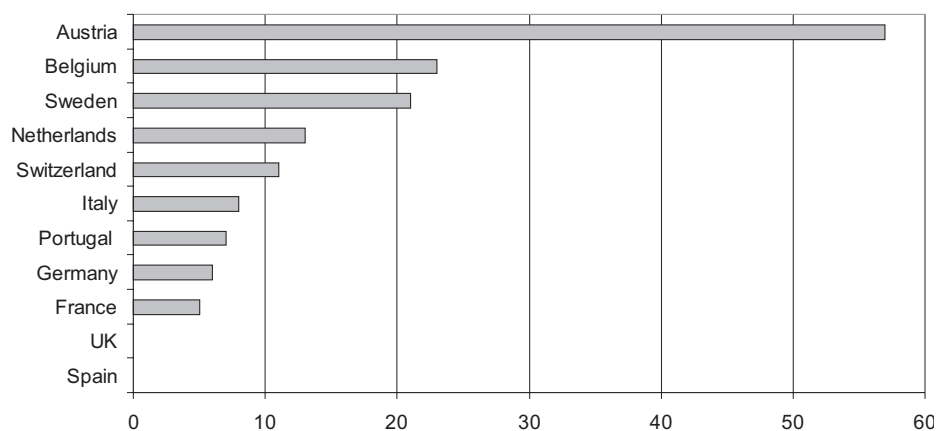


Figure 4. East European exposure of Western banks in 2008
(as percent of home country GDP)

Source: *Financial Times*, April 5, 2009.

Note: Exposure through local subsidiaries plus direct cross border exposure (% of home country GDP)

The voices of reason in EE, stating that comparing foreign-currency mortgages in the region to subprime mortgages in the USA was not appropriate, were initially not heard. The resulting scare contributed to the large further depreciations of the floating EE currencies during the spring of 2009 and to the strong attacks on the Baltic currencies that were tied to the euro.

There are many reasons why the foreign-currency mortgages in EE should not be compared to subprime mortgages in the West while some of the reasons are now quite known; during the first half of 2009 they were not realised or given much credibility in the West.

1. Practically no foreign-currency mortgages were given in the Czech Republic and Slovakia (*Figure 3*) and it was not a problem in Slovenia which had adopted the euro earlier. In the four EE countries with exchange rates pegged to the euro, such loans were not supposed to be a problem, provided of course that the fixed exchange rates could be maintained, an assumption that was taken for granted until late in 2008. In the remaining three EE countries with EU memberships, foreign-currency loans to households were of varying relative importance (*Figure 3*); they were the highest in Hungary. To be sure Ukraine and several Western Balkans countries also had such loans, which made the debtors and their creditors vulnerable to exchange rate depreciation (the only vulnerability being discussed in the present context).

Figure 5 shows the growth in Hungary of commercial bank lending to households in foreign currency, mostly mortgages. Let's use the example of Hungary to further indicate why it is not appropriate to compare foreign-currency mortgages in EE with subprime mortgages in the West.

2. In the West, household debt to GDP ratios are approximately 60% in Euroland, around 100% in the USA and in the UK, and well above 100% in the Netherlands, Denmark, and Iceland. The comparable figure in Hungary is 36%. This means that the fast growth of mortgages during the current decade (in domestic or in foreign currency) reflects in good measure the low base.

3. In the USA, the UK, Ireland, and Spain many who were given mortgages in order to promote home ownership were truly subprime borrowers. In Hungary (and presumably in most of the other EE countries), the mortgages – in domestic currency or in foreign currency – were granted mostly to the emerging middle class.

4. In the West, the ratio of loans to collateral value was high. In Hungary, the ratio of loans to the value of the collateral was much lower than in the USA (at the end of 2008 around 65% vs. 95%).

5. In the West, mortgage lending grew rapidly because housing and real estate prices were projected to continue to rise, encouraging speculative borrowing.

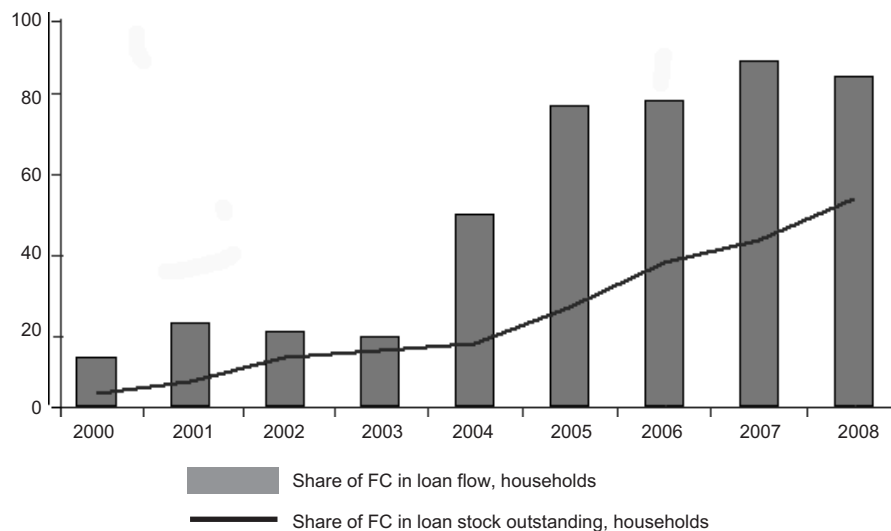


Figure 5. Hungary: Commercial Bank lending to households in foreign currency, 2000–2008

Source: OTP Bank (privately communicated). In 2007 the loan flow in FC exceeded 100% because repayments in HUF were larger than new loans extended in FC.

When the bubble burst, the value of the collateral collapsed and many borrowers walked away. In Hungary, there was little real estate speculation (although in the Baltic States, Romania and Ukraine there was a great deal), so there was no bubble to burst, at least in Hungary.

6. In the West, the financial institutions granting mortgages typically packaged and sold those and other assets, along with unregulated financial instruments, often with very high leverage (30 or more to 1). In Hungary and elsewhere in the region, the banks granting mortgages did not resell them; the risks remained on the lenders' balance sheets. And the banks have been making accommodations to those who are able to pay but are facing hardships due to the plunge in the values of the local currencies and other temporary hardships. And leverages in banks throughout EE are very much lower – on average, about a third – of what they are in the USA and the UK.

7. Banks in EE have not, as a rule, invested in the kinds of super-sophisticated (but what turned out to be) toxic assets that have caused such large losses in the USA and in certain Western European countries (such as for the Landesbanken in Germany).

8. Finally, in countries with flexible exchange rates and large foreign-currency loans, the rates can go not only down but also up, as they did after June 2009 in all the EU member EE countries with floating regimes.

For all these reasons, losses and outright defaults on mortgages were, and will remain, relatively lower in Hungary and in most of the other EU members from the region, than, for example, in the USA or in the UK.

There are, of course, bank failures in EE – greater in number and more severe in some countries (such as Ukraine) than in others.

While excessive fears about Western European exposure to banking problems in EE have proven to be unwarranted, the combination of foreign ownership of banks, the rapid expansion of domestic credit, and the impacts of the global crises have created vulnerabilities to home and host countries alike in Europe and have made crisis management more difficult in the countries most heavily indebted in foreign currencies.

The actual degree of vulnerability of an EE country's banking sector depends on such factors as the impact of the global crisis on the respective parent financial institutions; the parents' treatment of their subsidiaries in EE; the host country's macroeconomic fundamentals; the capitalisation, liquidity, and general soundness of the host country's banking system; the size and maturity structure of foreign claims on the country; and the nature of the institutional regulations that affect financial relations between home and host institutions (Árvai 2009: 5).

Fear that Western subsidiaries will abandon EE

Perhaps the most worrisome concern about the adverse impact of the global financial crisis on EE was that the parent banks, facing difficulties at home, would drastically reduce their Eastern exposures or withdraw altogether, triggering a massive financial crisis in the region. The initial, uncoordinated responses of Western European governments to the global liquidity crisis, such as announcing higher deposit guarantees for bank customers in their own countries without regard to the resulting cross-border "flight to safety" transfers, seem to have given credence to concerns that Western European banks might act irresponsibly in EE.

Through the end of October 2009, these fears did not materialise and are less and less a cause for worry:

1. Western European banks have made long-term, strategic investments in EE, which they do not want to abandon, especially since growth in EE is expected to resume. Banks are also mindful of impairing their global reputations if they act irresponsibly in EE.

2. The last thing that European governments and the EU would want is a banking crisis and the resulting economic collapse in EE, which would trigger not only economic problems for the West but also social and political instability on their

borders, resulting in more migration. Therefore, many Western European governments have made it explicit that they expect that an appropriate share of any emergency official assistance provided to banks in their home countries would be made available to support subsidiaries in EE.

3. In several EE countries hit particularly hard by the global crisis – including Hungary, Romania, Latvia, Serbia, and Bosnia – the IMF took the initiative of bringing together the CEOs of these countries' main parent banks, representatives of the World Bank, the ECB and the EU, and government officials and the monetary authorities of the EE country as well as those of the Western bank's home countries. The purpose of these meetings was to pressure the CEOs to make public pledges of continued support of their operations in EE and to show that the pledges are backed by the international financial institutions as well as by the relevant national authorities.

4. Finally, the well-timed and substantial rescue packages that the IMF put together for several EE countries late in 2008 and early in 2009 helped to stabilise their banking systems. In several instances one of the publicly stated purposes of the rescue packages was to support the authorities in EE in coming to the aid of local banks, irrespective of ownership.

To conclude, banking system problems in EE – considering the non-separable combined impacts of the global liquidity, financial, and economic crises – are serious but are generally not as severe as they are in the US or in most countries in Western Europe. Banks in EE have had few of the kinds of toxic assets or high leverage that had triggered the problems in the USA and in several other Western countries. Foreign-currency mortgages granted in some (and only in some) of the EE countries cannot be likened to the subprime mortgages in the West. The timely provision of IMF rescue packages for the EE countries hardest hit by the global crisis helped the authorities in managing problems in the banking system. And the predominant foreign ownership of EE's banks is turning out to be, on balance, an advantage.

Impacts of the crisis in the global real economy

After a brief period of hope that Europe will avoid, or suffer a milder version of, the financial and economic crisis that originated in the USA, the last four months of 2008 saw the emergence of a global, synchronised recession.

The real economies of EE have been hit simultaneously – though in varying degrees – by three interdependent external shocks: the global financial and liquidity crises, causing severe constriction of foreign and domestic credit to businesses

and households; dramatic declines in capital inflows, which cut investment as well as credit; and plunging demand for their exports, which quickly had a direct negative impact on EE's GDPs and employment.

It is not possible, of course, to estimate separately the impacts of these three interdependent and mutually reinforcing external shocks. But some relevant observations can be made.

One is the great importance of foreign trade for the countries in the region. In each of the ten relatively small EE countries, foreign trade participation ratios are high and have been climbing steadily through 2007 as a result of their growing global economic integration. Therefore, slumping global demand for imports has severely hurt all of these countries. While Russia, Ukraine, and Central Asia have much lower trade participation ratios than the rest of EE, which is helpful, they had suffered large terms of trade losses, although as of mid-2009, energy and raw material prices have started to climb back.

Second, while there are many factors, often country-specific, that influence the impact of the global crises on EE's real economies, *ceteris paribus* the global crisis has hurt relatively more the economies of those countries whose governments have followed less prudent, less responsible economic policies during boom times.

One measure of macroeconomic prudence is the differences among the countries during the crisis in their so-called "sovereign spreads", where we saw Hungary and Latvia to have been at a disadvantage.

Another measure of macroeconomic prudence is the extent of a country's compliance with the five Maastricht convergence criteria for euro adoption. The ten EU member EE countries differ substantially on this. Slovenia and Slovakia were clearly in the lead as they had already entered the Euro-zone. The other eight have been able to satisfy some of the criteria but so far could not meet all of them at the same time. As of 2007, the Czech Republic and the three Baltic states had met 4 of the 5 criteria; Hungary had met only one! An IMF report observes: "Hungary with its large fiscal deficit, high inflation, and external debt was an early victim of the crisis" (IMF 2009a: 51).

At the end of 2009, Latvia continues to be in a crisis mode; the reasons were summarised in our brief country study. However, Hungary has responded to the crisis with decisive steps. Thanks in large measure to having looked into abyss (being close to having to default on its large external sovereign debt), the interim government led by Gordon Bajnai was able to turn things around during the past six months (April – October 2009), greatly improving Hungary's prospects: The large budget deficits were cut (while they skyrocketed in much of the developed West), and some of the needed structural changes in the economy (e.g. in the tax system) had begun.

4. PROSPECTS AND RECOMMENDATIONS

This concluding section does not offer quantitative economic projections for any EE country. Rather, it discusses the most probable global economic environment, focusing on Western Europe, and speculates about the kind of “growth model” modification that would appear to be necessary for the countries of EE to adapt to the post-crisis global-regional environment.

Slow growth in the EU

At the time of writing (November 2009) it appears that the worst decline in global economic activity is now over in most countries. However, looking at the fundamentals, the timing and the shape of the recovery remain highly uncertain.

Critical for the countries of EE is the shape of Western Europe’s economic recovery. Will it be V-shaped, with a rapid return to the pre-crisis growth rates; or U-shaped, that is, anaemic and below trend for some time to come, after a couple of quarters of good growth driven by the recovery of export production for the revived world market and by a restocking of inventories? Alternatively, will it be W-shaped, in which a recovery, propelled by massive fiscal spending and expansionary monetary policies, is followed by another downturn, as the financial problems of banks remain fundamentally unsolved?

I find the arguments of those who predict a U-shaped recovery and modest medium-term growth to be the most persuasive:

1. Few of the advanced economies have managed as yet to restore the health of their financial sectors, which will act as a drag on lending and thus on growth.

2. As the current-account deficits of profligate economies, such as the USA and EE, will continue to narrow, it is not likely that the domestic demand of over-saving surplus countries (China and other emerging markets in Asia, Japan, and Germany) will grow fast enough to pick up the slack. The main reasons are that consumption and saving patterns are partly determined by cultural fundamentals and that emerging from a scary global crisis will not be conducive for starting a consumer spending splurge.

3. The exit strategies that are the most likely after 2010, following several years of highly expansionary fiscal and monetary policies will constrain growth as government spending is reined in and taxes go up. In the case of Euroland, a further constraining factor will be its strong currency, making it harder for exporters to compete on the world market.

If the recovery and growth of Western Europe will indeed be slow, that does not bode well for EE, either in the short- or in the medium-run because it would provide diminished external support for EE's continued rapid growth.

Economic growth in Eastern Europe: the old versus the new model

The economic strategies of the EE countries, which yielded, on balance, impressive growth for about a decade prior to the global crises, had three pillars, labelled here as *EE's growth model* (Fabrizio et al. 2009).

1. Their extraordinarily rapid trade and financial integration into the global economy, as shown by the fast increases in their foreign trade and foreign financial participation ratios in GDP.
2. Large capital inflows that made possible the rapid growth of productivity and improved living standards, with the inflows helping to finance large current-account deficits.
3. Appreciating real exchange rates, which contributed to improved living standards and keeping inflation in check.

The hallmark feature of this model was that a significant part of the region's growth was externally-generated or supported: growing trade and financial integration into the global economy, combined with large net capital inflows. If the recovery and growth of Western Europe will indeed be slow, that means that EE's past rapid trade and financial integration into the EU will also be slowed. Net capital inflows and FDI are likely to be smaller, too, in part because of the growing attractiveness of China and Asia's other developing countries.⁸ If these assumptions are correct, then in the future EE will have to rely relatively more on internally-generated sources of productivity growth and competitiveness.

Make no mistake: this statement does not suggest that the EE countries should turn inward, or become protectionist, or to pursue growth led by import substitution. The relatively small, open economies of EE have no option other than remaining or becoming globally competitive and export oriented. The statement suggests only that more of the factors that enhance global competitiveness through improved productivity will have to be internally generated. To mention just four such interdependent factors among many: (1) substantial increases in employment, mainly by cutting the share of "inactives" in the working-age popu-

⁸ A more optimistic scenario would envision China, India, Russia and the oil-rich Middle Eastern countries picking up the capital-inflow gap from Western Europe.

lation; (2) reducing tax evasion (which requires reforms in the tax structure); (3) improving the efficiency of government at all levels; and (4) seriously fighting corruption, which has remained pervasive throughout the region.⁹

Improving these and many other factors that are largely within the control of a nation's authorities, industries, firms, and workforce would require no large new expenditures, only the political will to address them. These can be, should be, the major, new, domestically-generated sources of enhanced productivity and improved competitiveness in EE.

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⁹ These and many other internal sources of growth can be found, comparatively, for more than 130 countries, in the annual *Global Competitiveness Reports*, published by the World Economic Forum (2008). The most recent, 2009–2010 report was issued in September 2009.