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Causes of the Crisis, Its Transmission to Eastern Europe, and Impacts on Economic and Social Conditions

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Contents

I. 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 necessary and attempted by the USA and Western Europe (Section II). While some may find the summary useful in its own right, its primary purpose is to serve as a framework for discussing developments and prospects in EE.

Neither the causes nor the remedies of the crisis in Eastern Europe are identical to those in the USA or in Western Europe. The economic strategies of the EE countries, and how the global crisis was transmitted to EE, had certain broad commonalities in the region (Section III). There are also significant, country-specific differences (Section IV). The concluding section, "Impacts, Responses, Outlook, and Recommendations" (V) stands partly as a summary of the paper's key points and partly as a glance into the future global and regional environment and speculates about their action implications for EE governments and USAID.

Three appendices round out the paper, "Hungary: From Leader to Laggard" (A); "The Caucasus and Central Asia" (B); and "Actions to Restore the Health of Country Financial Systems" (C).

II. Causes and Remedies of the Global Crisis

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.

(2) The emergence of new types of financial instruments in the developed West whose dramatic growth was fueled by incentives that made individuals and financial institutions rich without it being realized that, in the process, a huge, system-wide financial time bomb was being created.

(3) The developments stated under (1) and (2) were taking place while policymakers and regulators were dozing at the wheel. An evidence of dozing is that there was no "what if" plan for a financial crisis. Consequently, early reactions to the crisis were haphazard and often inept.

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. This led to an excess of intended global savings relative to intended global investment, causing a dramatic decline in long-term interest rates. 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. EE did likewise, its people and governments being impatient to converge to West European living standards.

As bond yields declined and stock yields followed, investors began to look for assets that would generate the earlier higher returns. The solution was "alternative investments": hedge funds, real estate, venture capital, private equity, derivatives, and commodity futures. The financial wizards created obscure, unregulated financial instruments, packaged them and traded them, often with very high leverage of 30 or more to 1.[1]

The speculative new instruments and the high ratios did, for a time, generate large profits in the financial sector, but also asset bubbles. As someone aptly put it: "[This process] was abetted by mortgage originators who had little interest in making sure loans were good quality, investment banks that securitized and packaged those loans, rating agencies that forgot the fundamental laws of gravity, and purchasers who bought securities they could not possibly understand."[2]

The bubble burst in 2008. Banks and other financial intermediaries suffered huge losses and were bracing for more. Initially no one knew how much more the losses would be, for an institution or system-wide. Consequently, private credit markets froze: no one wanted to invest in or lend to banks, or they to each other, in the crisis situation.

To survive, banks were desperately trying to "deleverage". Let us recall (note 1) that leverage is the ratio of risk-weighted assets to equity. Deleveraging means one of two things: reducing the denominator by selling assets whose risks, in many cases, suddenly jumped and market values plunged, often with no private buyer in sight. Or increasing equity, but who is going to invest in banks? In fact, realized or expected losses reduce equity, which itself ***increases*** leverage.

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 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 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.

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. 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]

Massive new fiscal spending and expansionary monetary policies are relatively easy tasks, 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 recession, stimulus via deficits to create demand and jobs has broad public support. But spending huge sums of taxpayer money to buy impaired ("toxic") assets and to recapitalize banks and other financial institutions – perceived as the main culprits of the crisis – is controversial and thus 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]

In April 2009 the IMF estimated that between 2007 and the end of 2010, the US, European and Japanese financial sectors will face cumulative losses of $4.1 trillion, of which banks are confronting $2.5 trillion in losses.[5] Of the $4.1 trillion, $2.7 trillion were attributed to the US, $1.2 trillion to Europe, and $.2 trillion to Japan.

As of March 2009, US banks have written down roughly half of their $1 trillion of estimated losses, UK banks about 30% of their $310 billion in anticipated losses, while Eurozone banks only 17% of their $900 billion of projected losses. It is possible that the IMF's $900 billion loss estimate for Eurozone banks is low, given that in early May 2009 Germany's Minister of Finance proposed to set up a "bad bank" to cleanse the country's lenders of an estimated Euro 850 billion (nearly $1.2 trillion) of toxic assets.[6]

Conventional wisdom has it that problems in the US residential mortgage sector had triggered the global financial crisis. Problems in the residential mortgage sector then spread to the commercial real-estate sector, to other consumer loans (e.g., credit cards), and more recently to the corporate sector. Considering that the EU and the USA economies are roughly of similar-size, how is it possible that banks in Europe combined are projected by the IMF to have more red ink through 2010 than US banks? And the IMF may well have underestimated the Eurozone banks' likely losses.

The main reason why bank losses in the USA are expected to be smaller than in Europe is the difference in the relative sizes of their banking sectors. Whereas in the USA, the banking sector and the securities sector were of roughly equal size in early 2009 ($13 trillion in bank loans outstanding and $13 trillion in stocks), in Europe the banking sector dominates ($21 trillion in bank loans outstanding and only $3 trillion in stocks).[7] Consequently, stock-market losses were much larger in the USA than in Europe and banking sector losses are relatively larger in Europe.

While many West European banks (especially in the UK, Ireland and the state-owned "Landesbanks" and specialized banks in Germany) suffered mortgage, real estate and other losses similar to US banks, Continental West European banks were generally less exposed to financial speculation than their Anglo-American counterparts.[8] The recession came to Europe with nearly a year's delay. Eurozone GDP contraction is now steeper than that in the USA. The main reason is Europe's much heavier reliance on trade, whose collapse is hurting their economies, and thus their banking sectors, more than in the less trade-dependent USA

Another potentially large loss for West European banks is their huge exposure to EE, where banks in many countries are owned predominantly by parents in Western Europe.

III. Transmission to the East: Commonalities

East Europe Defined

For our discussion, EE – defined as the neighborhood's transition economies -- is comprised of 29 countries, organized into the following, not-fully-homogenous groups (countries that still receive USAID assistance are marked *):

Central and Northern Europe (10 new EU members)
- 2 Euroland countries (Slovenia as of 2007 and Slovakia as of 2009)
- 5 Other Central Europe (Poland, Czech Republic, Hungary, Romania, Bulgaria)
- 3 Baltic states (Estonia, Latvia, Lithuania)

West Balkans
- 7 countries (Albania*, Bosnia*, Croatia, Kosovo*, Macedonia*, Montenegro*, Serbia*)

- 1 Russia*
- 1 Ukraine*
- 2 Moldova* and Belarus*)

Caucasus and Central Asia
- 3 countries in the Caucasus (Armenia*, Azerbaijan*, Georgia,*)
- 5 countries in Central Asia (Kazakhstan,* Kyrgyzstan,* Tajikistan,* Turkmenistan,* Uzbekistan*)

Given the particular interest of the Conference organizers and participants in those six countries of the West Balkans that are eligible for USAID (marked *), as well as in our host country, Ukraine, this section and the next try not to neglect them, even though less relevant comparative information is available on them than on the EE member states of the EU. Some attention will also be paid to Slovenia, a country that in certain ways is an appropriate reference for the countries of the West Balkans.

Commonalities in Eastern Europe

As broad generalizations, the following ten commonalities characterize the region; important exceptions are noted.

1. *Impressive transformation* during the last two decades from inefficient central planning and political dictatorship to democracy in most countries and to political pluralism in most of the others, along with predominant reliance on the market mechanism to allocate resources.

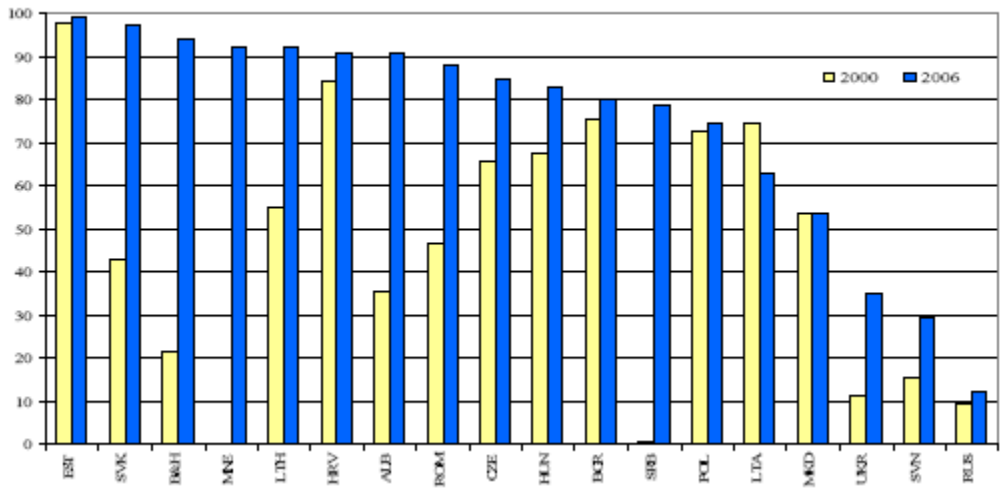
2. For the past 20 years the *integration into the world economy* has been remarkably successful, leading to a greater degree of interdependence between east and west than perhaps ever before. This is especially so for the ten EE countries that had joined the EU -- guaranteeing the free movement of goods, services, capital and labor. Integration meant that a region with relatively scarce capital and an abundance of inexpensive and skilled labor became integrated with a region with abundant capital and expensive labor. Thus, it made economic sense to have large capital flows from West to EE. This caused productivity in the East to rise faster, pulling up real wages.

3. For well over a decade, until 2008, all EE countries had been *net importers of capital*, except Russia. Capital was obtained through large net inflows of foreign direct investment (FDI), portfolio investment, private and official borrowing from global credit markets and from regional and international financial institutions, and in the form of Western, mainly EU, aid.

4. The EE countries' *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 1** 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%.[9] In Ukraine, the share was close to 40%; in Russia, 10%.

[Figure 1 goes about here]

Figure 1. Asset Share of Foreign-Owned Banks, 2000-06, in percent



Source: Zsofia Arvai, et al., "Regional Financial Interlinkages and Financial Contagion within Europe" (IMF Working Paper 09/6, January 2009), p. 6.

Foreign ownership of EE 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 the 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 enabled the rapid growth of incomes in EE, thereby facilitating the convergence process. The rapid growth of credit also generated large profits, but also vulnerabilities, for the parents through 2007.

The most exposed West European countries, through their banks' involvement in EE at the end of 2008, are shown in Figure 2 (*Financial Times,* April 5, 2009). Austria is by far the most exposed, followed by Belgium and Sweden.

[*Figure 2 goes about here*]

Figure 2. East European Exposure of Western Banks in 2008
(As Percent of Home Country GDP)

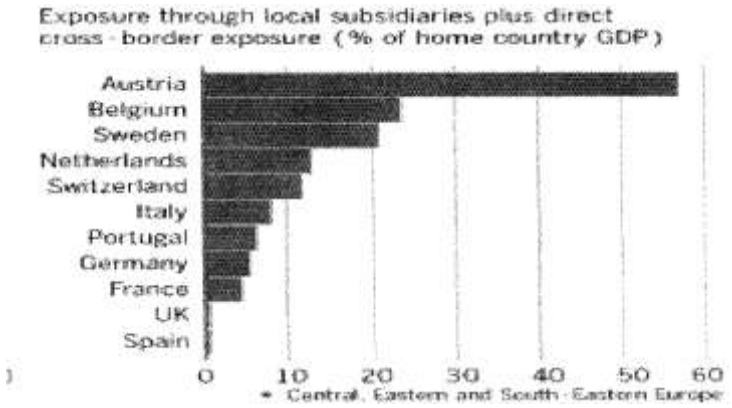


Table 1 shows the average annual growth of credit between 2004 and 2007, by country and region. The median as well as the average **real** rate of growth of credit for all of EE was close to 30%. Some of the rapid growth is explained by the process of enhanced financial intermediation from very low levels (Albania, Belarus, Macedonia, Serbia, Ukraine, Russia, Romania, and Bulgaria); in certain countries credit growth was unsustainably high, generating bubbles that burst when the global financial crisis hit the region (the Baltic states, Ukraine, Russia, as well as Romania and Bulgaria).

[*Table 1 goes about here*]

The combination of dominant foreign ownership of banks and the rapid expansion of credit also created **potential** vulnerabilities to host and home countries alike. The actual degree of vulnerability of an EE host country depends on such factors as the impact of the global crisis on the respective parents; the parents' treatment of their daughters in EE; the host country's macroeconomic fundamentals; the capitalization, liquidity, and general soundness of the host country's banking system; the maturity structure of foreign claims on the country; and the nature of the institutional regulations that affect financial relations between home and host institutions.[10]

Table 1. Average Annual Real Credit Growth in East Europe by Country, 2004-07

Central and Northern Europe	
Estonia	47%
Lithuania	42%
Latvia	41%
Romania	39%
Bulgaria	33%
Slovenia	(*25%*)[11]
Czech Republic	18%
Poland	16%
Slovakia	15%
Hungary	12%
West Balkans	
Albania	51%
Serbia	25%
Macedonia	25%
Bosnia & Hercegovina	20%
Croatia	14%
Other Eastern Europe	
Ukraine	44%
Belarus	38%
Russia	32%
Moldova	22%

Source: Same as Figure 1, Table 1.

5. *The global financial crisis impacted EE with a delay.* The financial turmoil, which originated in the US, affected heavily exposed economies like Ireland and the UK first, and then spread rapidly to the key economies of Continental Western Europe. In contrast, the EE economies displayed remarkable resilience for a long time. It was only after the leading economies in the West plunged into recession that EE began to feel the full impact of the global crisis.[12]

6. ***The impact of the crisis was (and is being) transmitted to EE through three channels*. The main channel is *plunging demand* by Western European (and other) importers *for EE's exports*, on which most countries in the region so heavily depend. This has multiplier effects on EE's domestic economies. Another channel is *the abrupt halt* -- in some cases, reversal – *of* large *net* FDI and other *financial inflows*. A third important channel is *the increased difficulty of obtaining, and the higher cost of, credits* from the parents and from global capital markets. For some countries and for some periods, external credit simply became unavailable. While in many EE countries cuts in bank lending were justified after a period of unsustainable growth, the sudden and widespread unavailability or high cost of credit had the same dramatic impact on EE's real economies as they did in the US and Western Europe.**.

7. *All EE countries are now in a recession*. In some countries the GDP decline has been double digits. Depending on the duration of the decline, economic historians might label the downturns as depressions, at least in some countries,. At the time of writing (May 2009) the average GDP decline for 2009 is forecast to be about the same in EE as in West Europe, around 6%.[13]

8. ***Banking system problems in EE are serious but are generally not as severe as they are in the US or 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, the UK, Ireland, and Iceland.** To be sure, several EE countries did experience wild domestic credit and asset market booms and bubbles before being hit by the global credit crunch. For example, Ukraine saw a credit-fueled private sector investment boom. As its economy collapsed and currency plunged, widespread defaults have led to a banking crisis, with seven systemically important banks being nationalized. Latvia had an overheated property market, fed by lax credit, excessive borrowing, and complacent regulators. Even in Hungary -- and elsewhere, too -- banks were pushing mortgages and other loans to consumers that, in some cases, were quite risky.

Even so, the majority of the countries in EE have, by and large, pursued responsible banking policies. Although banks throughout the region have and will continue to have significant loan losses as global recession plummets their economies' exports, their banking systems' current and prospective losses are more or less covered by their profits, reserves, equity, and borrowing capability, as needed.[14]

9. ***If and when additional loans or capital is required* to sustain the foreign-controlled banks in EE, there is convincing evidence that, in most cases, *the parents in Western Europe will continue to provide* them, in many cases with financial support from their governments**. Large banks in Western Europe have made long-term, strategic investments in EE, which they would not want to abandon. And they cannot impair their world-wide reputations by defaulting or acting irresponsibly in EE. And the last thing that European governments and the EU would want is a banking and economic collapse in EE, which would trigger social and political instability on their borders, resulting in more migration.[15]

10. **Finally, *the EE countries*, including Ukraine, facing balance-of-payment difficulties and other types of external financing problems *have been, and will continue to be, helped externally* by European and international financial institutions, with a portion of some loans earmarked for supporting their banking systems**. (Russia has sufficient reserves to assist its banks, if needed.) Since in response to the global financial crisis the IMF has obtained large additional resources from its members, once again it has started to play a catalytic role in assisting the emerging economies. Between September 2008 and May 2009, of the IMF's total new global resource commitments of $155 billion, 53% was made to the countries of EE (Table 2). The EE countries are potentially eligible for two types of IMF loans, the traditional,

short-term, "Stand-by Arrangements" and the newly established "Flexible Credit Line" arrangement.[16]

[*Table 2 goes about here*]

Table 2. IMF Financial Arrangements in Eastern Europe as of June 2009 (Millions of SDR)

Member	Effective Date	Expiration Date	Amount Agreed SDR[17]	USD
Stand-by Arrangements				
Georgia	9/15/08	3/14/10	477	739
Ukraine	11/5/08	11/4/10	11,000	17,034
Hungary	11/6/08	4/5/10	10,538	16,318
Latvia	2/23/08	3/22/11	1,522	2,357
Belarus	1/12/09	4/11/10	1,618	2,500
Serbia	1/16/09	4/15/11	2,619	4,056
Armenia	3/6/09	7/5/11	368	570
Romania	5/4/09	5/3/11	11,443	17,720
Non-EE (7 countries)			8,454	13,091
Flexible Credit Line				
Poland	5/6/09	5/5/10	13,690	21,200
Other (Mexico & Columbia)			38,494	59,600
Total			100,222	155,194
East Europe			**53,275**	**82,500**
Other			46,947	72,694

Source: IMF, "Financial Activities – Update June 4, 2009. USD calculated, based on SDR 1 = $1.5485. The dollar amounts of reported IMF loans may differ slightly, depending on the SDR/$ exchange rate.

It is worth noting that in May 2009 Kosovo was admitted to the IMF**,** with an initial quota of SDR 59 million (about $89 million).[18]

Other international financial institutions, such as the World Bank, the EBRD, and of course and EU are also providing substantial financial assistance to the countries of EE, not detailed here.

IV. Transmission to the East: Selected Differences

Space limitations allow us to highlight on four significant, transmission-relevant differences among the EE countries, in addition to those already mentioned in the previous section: (1) Natural differences owing to size, resource endowment, levels of development, and so on; (2) the relative size of fiscal deficits; (3) differences in exchange rate regimes, with particular attention to the role of the euro; and (4) the extent of foreign-currency borrowing.

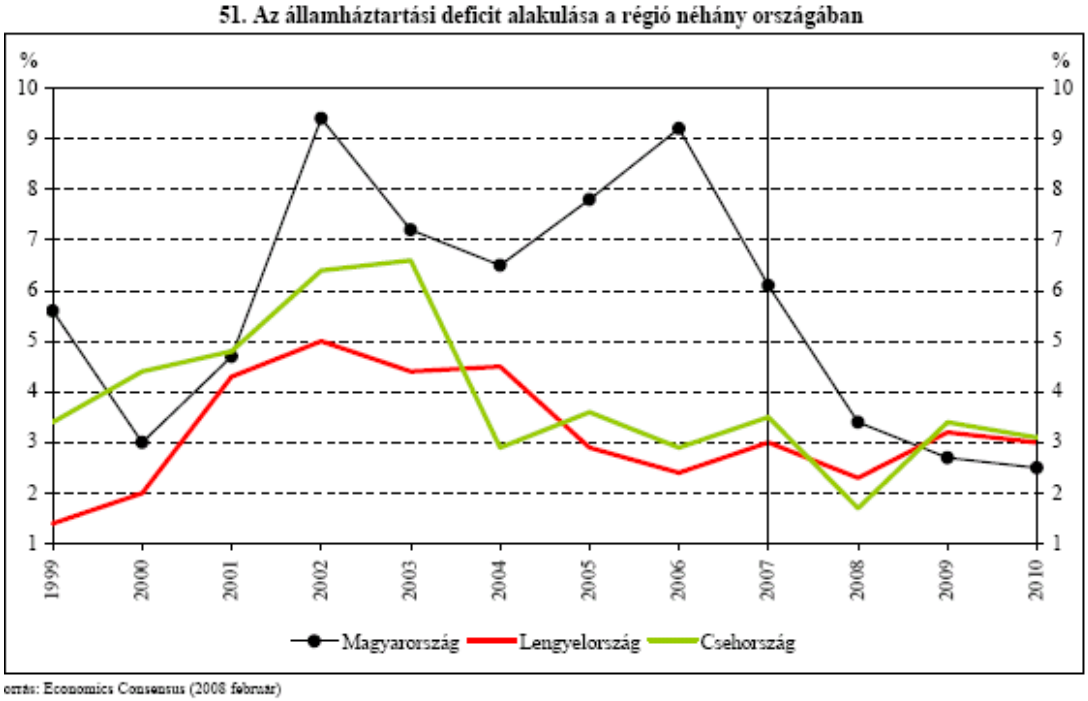
1. The range is immense in which the EE countries' *territorial and economic sizes, per capita incomes, resource endowments, political systems, and cultures* fall. This has to be kept in mind at appropriate points in any comparative analysis.

2. As in the West, the economic crisis requires EE governments to act on two fronts: to undertake massive additional fiscal spending until the private sector recovers, and to restore the health of the financial sector. Massive new fiscal spending and expansionary monetary policies are relatively easy for countries whose governments have not impaired the country's credit-worthiness through sustained profligate spending during boom times. In this respect there are notable differences among the countries.

Figure 3 shows *budget deficits as percent of GDP* for Hungary, Poland and the Czech Republic for 1999 – 2010 (the current year and the next are forecasts). What stands out is how absolutely and relatively high were Hungary's budget deficits during the boom years of 2001-2007, when government debt as percent of GDP rose to 66%; by early 2009 it reached about 75%. Hungary's consolidated government debt (according to the standard Maastricht criterion) is one of the highest in the EU and in EE.[19] Appendix A discusses how Hungary got into this situation. The lesson it has been learning is instructive for all the EE countries, especially for those in the West Balkans.

[*Figure 3 goes about here]*

Figure 3. Annual Budget Deficits as Percent of GDP in Hungary, Poland and the Czech Republic, 1999-2010



forrás: Economics Consensus (2008 február)

. GDP arányában. Csehország és Lengyelország esetében az egyenleg nem tartalmazza a privatizációs bevételeket.

The foregoing has implications for crisis management. Hungary, which had persistent large deficits during boom periods, is now unable to rely on extra stimulus spending to mitigate the recession. Monetary policy easing is constrained as well by the need to

ensure reasonable currency stability and to offer attractive interest rates to find domestic and foreign buyers for refinancing the outstanding and financing any additional government debt. As a consequence, recovery is likely to be delayed and future growth potential impaired.

3. An important difference among the EE countries is in their choice of *exchange rate regimes*, that is, the rules that establish how a country's exchange rates are to be determined, and the related issues of *whether, when, and how to try to adopt the euro.* Adopting the euro means fixed exchange rates vis-à-vis the Euroland countries, their main trade and financial partners, and having a currency that is trusted, domestically as well as abroad.

Only EU members have the right to join Euroland; in fact, the 10 EE countries that became EU members since 2004 have the obligation to do so, but only when they are "ready". 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 members don't have to worry about the often large costs of currency fluctuations and because membership provides "cover", for example, via access to European Central Bank (ECB) credits.

Adopting the euro also has costs. Most important is that the country automatically looses a key instrument of monetary policy, namely that of 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 in real terms – 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. (One manifestation of changing competitiveness is the rise of cross-border shopping in 2009, for example, Slovak, Slovenian, and Baltic consumers shop in Hungary, the Czech Republic, Poland, and the Ukraine.) 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.

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 Eurozone entry, a country must spend at least two years in the so-called exchange rate mechanism (ERM-2), during which its currency must remain within 15% of either side of its announced central rate vis-à-vis the Euro.

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, those 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 country there has been 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.[20]

Of the ten East European members of the EU, Slovenia and Slovakia had adopted the euro and four others have tied their currencies to the euro (the Baltic states and Bulgaria). The discussion here will focus on their experiences and the lessons learned. The other four EU members from the region have managed floating exchange rates, with plans and (often moving) target dates for adopting the euro.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. (One exception is Belarus, which has pegged its currency to a basket, following a recent devaluation. Another is Kazakhstan, which pegs its currency, the *tenge*, to the USD, allowing plus/minus 3% fluctuations.)[21]

For some of the non-EU countries of EE, adopting the euro is a distant "maybe", a possibility only if and when the country is admitted into the EU. For others, such as the Central Asian countries and of course Russia, the euro is not in the cards. For Ukraine, it is doubtful in the foreseeable future.

Slovenia was the first in the region to adopt the euro, in 2007. Aided by broadly favorable initial conditions and generally sound macroeconomic policies, Slovenia had achieved impressive growth rate for a sustained period, with small external imbalances, while gradually lowering inflation to euro-area levels. Following the euro's adoption, inflation accelerated during 2007-08 (cost-push and demand-pull being the main causes, the Euro's introduction a minor cause), which then moderated in 2009.[22]

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

Since the introduction of the euro, Slovenia has lost some external competitiveness, "owing to rising unit labor costs and depreciations in the currencies of neighboring countries."[23] *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, including those in the West Balkans, is that maintaining or enhancing*

competitiveness requires the authorities to pursue with equal fervor prudent macroeconomic policies as well as structural reforms in the economy.

Slovakia was the second, joining at the beginning of 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 2006-08 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 the authorities to make people and businesses feel relatively "wealthy" upon joining Euroland.

Owing to the facts that (1) Slovakia had borrowed relatively little abroad and (2) adopted the euro on a timely basis, it is in a much better position to weather the global crisis and to resume sustained growth when the European economies recover. However, its heavy dependence on exports, which are hurting badly, and inflexibilities in its labor market, are key challenges it must overcome. *Slovakia's experiences reinforce Slovenia's lessons for the other EE countries, including those in the West Balkans.*

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 so-called currency board arrangements.[24] **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 entry.

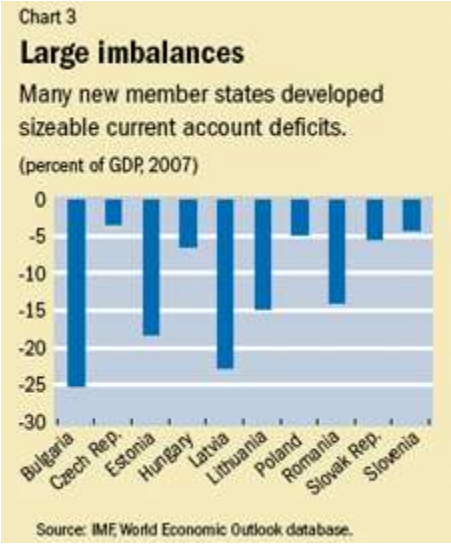
The Baltic countries have economic, historical, and political reasons for straining to introduce the euro. Having suffered hyperinflation is the historical experience that pushes them to desire one of the world's most prestigious currencies. Tying their countries to the West even more strongly is the political reason.

After a period of impressive growth, all three countries are now facing severe difficulties, essentially for similar reasons. The most extreme case is **Latvia.** Following acceptance into the EU, 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 (Table 1); a large buildup of *private external debt* amounting to about 130% of GDP; and a current-account deficit peaking at 25% of GDP in 2007, one of the largest in EE (Figure 4), in fact, in all of Europe.

[*Figure 4 goes about here*]

"When the global crisis erupted last year, resulting in a sudden stop of the capital flows that had financed the boom, these vulnerabilities created a perfect storm." [25] The authorities, allowing the economy to overheat and to become vulnerable to such an extent, are certainly not blameless. Latvia's external vulnerability increased also because its banks accepted large nonresident deposits, which were withdrawn in the wake of the global financial crisis.

Figure 4. Current-Account Deficits of Selected EE Countries in 2007 (Percent of GDP)



Latvia's high inflation during the boom years, with a fixed exchange rate, drove up costs, making the country less competitive. A further cause of Latvia's loss of competitiveness was that much of the capital inflows that spurred economic growth went into 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.

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. (The EU's share is the largest, $4.3 billion; the IMF's $2.4 billion, as shown in Table 2.) Subsequently, the economy plunged much more than was foreseen in the program; the current (May 2009) forecast is an 18% GDP decline in 2009, the largest in Europe, and the government fell. The resulting loss of tax revenue is causing an estimated budget deficit of 9% of GDP, much higher than agreed to when the rescue package was negotiated. "The government's most immediate challenges", say the Baltic experts of the IMF, "are dealing with a dramatic loss of revenues and making large adjustments in the budget [on the expenditure side] to remain at a level consistent with the country's strategy of maintaining the peg to the euro."[26] The central issue in the short run is whether the government would be able to cut expenditures sufficiently drastically to satisfy the IMF and the EU, so they would unblock the next installment of the loan package and, at the same time, keep Latvia more or less on course for adopting the euro?

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 large 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.

> "It goes beyond that, though. The peg has been a symbol of Latvia's stability and independence, and has been in place since the country won independence from the Soviet Union in 1991. For the government, keeping the peg will lead to euro adoption within the foreseeable future. Latvia has a clear strategy in place: meeting the Maastricht criteria and adopting the euro by 2012. This … justifies, in their eyes, the current sacrifices. The EU and the Nordic countries support this strategy, too, provided the government fulfills the conditions for joining the monetary union."[27]

Given the substantial overvaluation of the *lat* (Latvia's currency) at its current peg, a currently hotly debated issue: will be possible to restore competitiveness without a significant devaluation? One of the world's most influential experts on such matters, Nouriel Roubini, does not think so. He likens Latvia's situation to Argentina's in 2000 and predicts a similar outcome:

> "A real exchange rate depreciation is necessary to restore the country's competitiveness; in its absence, a painful adjustment of relative prices can occur only via deflation and a fall in nominal wages that will take too long and exacerbate the recession."[28]

Let's assume that Latvia (and the other Baltic countries as well as Bulgaria) will be able to maintain their pegs at the current rate and adopt the Euro in two-to-three years. The longer-run challenge for government policy is this: what will drive competitiveness and growth when the currency is overvalued relative to productivity levels, when FDI and other inflows are likely to be much smaller than before the crisis, and when Europe's growth is expected to be sluggish for some time?[29]

The answer is that not only the countries that have adopted or have pegged to the euro but all the countries in the region must in the future rely more on internally-generated sources of productivity growth. That is, they will need to replace some of the growth in productivity and output that had been generated by large capital inflows (mainly FDI) and by booming world market conditions that made possible a more rapid expansion of exports (and thus imports) than the tempo of GDP growth.

Internally-generated sources of improved productivity are many. Just about all the important ones are listed in the annual Global Competitiveness Reports (GCR), published by the World Economic Forum.[30] Policymakers in the countries of EE can readily find the macro, mezzo, and micro (or business environment) factors where their countries lag behind competitors. Improving those, which in many cases would require no large new expenditures, only the political will to address them, can be major new sources of improved productivity and competitiveness.

We are fortunate that one of the key presenters at this Conference is a Principal Economist of the World Economic Forum, who I am sure will elaborate on this recommendation.

4. Large **foreign-currency (FC) borrowing**, noted above, is often cited as one of the special problems facing the countries of EE during the current global financial crisis. They also represent a potential problem for the parents as well, but let's focus here on the host countries, addressing the following issues: *(a) what motivates locals to borrow in FC and why are lenders accommodating? (b) Why are there large differences among the EE countries in the relative importance of FC loans? (c) What are the perceived problems with such loans? (d) Are the perceived problems exaggerated?*

(a) Between 1997 and 2007, the ratio of the private sector's credit from banks to GDP had increased steeply not only in all the EE member states of the EU but throughout the region (as implied in Table 1). During the same period the share of loans denominated in or indexed to a FC has grown from 4% to 15%.[31] Hungary is one of the countries that had relied increasingly on FC loans. Since the author has good information on that country, let's use it to illustrate the logic of motivation.

At the end of 2007 Hungary's gross FC indebtedness was 100 billion Euros (about $135 billion). Of this, 34 billion Euros (about $45 billion) were owed by the authorities; 66 billion Euros ($89 billion) by banks (mainly), corporations, and households.[32]

Hungary's official FC debt (about __% of total government debt) is high because the government has had large deficits since 2000 relative to GDP. Banks have large FC debt obligations because deposits in local currency have been growing more slowly than loan demand. Furthermore, each time a bank makes a FC loan to a business or household, banking regulations require that it match those FC assets with equivalent FC liabilities.

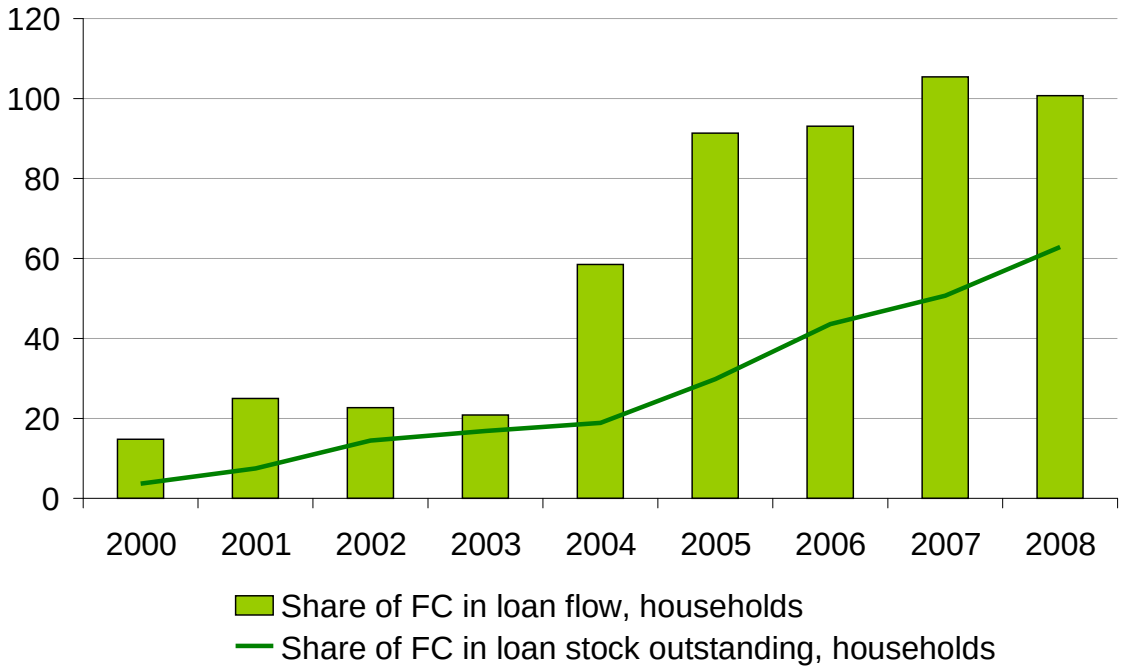
Figure 5 shows the rapid rise of Hungary's commercial bank lending to households, comprised mostly of mortgages.

[*Figure 5 goes about here*]

FC loans in Hungary and in the other EE countries were driven during this decade by the substantially higher interest rates on Hungarian forint (HUF) and other local currency investments than on comparable investments in the West. The much higher local-currency interest rates can be traced in large part to the government's pressing need to refinance and sell an ever-growing volume of government debt. The borrowers' interest-rate advantage in FC was reinforced by the nearly continuous real appreciation of the HUF and of the other EE currencies that had managed floating systems, made possible by economic convergence with Western Europe.

As the EE countries became integrated into the EU and with the developed West, it made economic sense to have large capital flows from West to East Europe. This caused productivity and growth in the East to rise faster than in the West, pulling up real wages. During convergence, inflation is expected to be higher in the East than in the West (known among the cognoscenti as the Balassa-Samuelson effect).

Figure 5. Hungary: Commercial Bank Lending to Households in Foreign Currency, 2000-2008



In the meantime, Hungary and the other EE members of the EU were getting ready – at different times - to join Euroland. A key precondition: inflation rates must be close to those in Euroland. This is achievable only through a significant, continuing real appreciation of their currencies, which is what theory predicts would happen as a result of the relatively faster growth of productivity. Between 2002 and September 2008 the HUF did appreciate in real terms by 22% between 2002 and September 2008, with comparable appreciations for the Polish zloty, the Slovak koruna, and the Czech crown. The currencies of most of the other EE countries that were not pegged also appreciated during this period.

During much of the current decade the main concern of Hungary's policymakers was the excessive strength of the HUF. On several occasions the National Bank of Hungary (NBH) had to intervene to prevent the currency from piercing the upper band of the exchange rate vis-à-vis the Euro. **And in the Baltic countries and in Bulgaria, whose currencies were already tied to the Euro for a long time, for that very reason borrowing in FC did not seem to be especially risky.**[33]

Following this logic, borrowing in FC was a rational choice by the private sector in the new EU countries as long as convergence toward the Eurozone was a reasonable expectation. To be sure, it was shortsighted, by lenders and borrowers alike, to assume that convergence will be continuous, that there would not be periods of currency depreciation or recession. Therefore, neither side was prepared for the problems that such developments would and did cause. And the banks, which were expanding rapidly in the region, were accommodating because they could readily

obtain inexpensive FC loans (often from their West European parents) and the FC loans they were making (in some cases, pushing) were highly profitable.

(b) There are striking differences among the 11 EE countries (ten EU members plus Croatia, countries for which staff at the IMF could make comparable computations) in the extent of their reliance on FC loans.[34] In Latvia and Estonia, the composition of credit to the private sector is highly biased toward foreign currency, probably for the reasons mentioned. At the opposite end are the Czech Republic (with practically no FC loans) and Slovakia, and Poland (with modest such loans). One may speculate that since these countries had pursued prudent fiscal and monetary policies and their governments did not accumulate large public debt, domestic interest rates – and thus the interest-rate differentials between local and foreign currency loans -- were much lower than in the other countries. Also, The Czechs have traditionally been financially more conservative than their neighbors. Hence **the large differences in vulnerabilities** among the EE countries.

(c) The *perceived problem* with FC loans on a large scale is the extra vulnerability of the individual and corporate borrowers as well as of the banks -- that is, vulnerability beyond normal credit risks - in case of a sustained decline in the exchange rate. A further vulnerability is that the country might have insufficient FC to service fully and on time its foreign debt

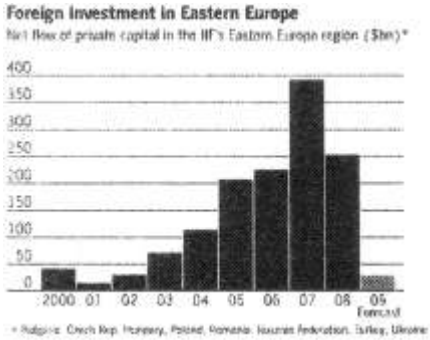
- if and when FDI, portfolio, and other FC inflows diminish greatly,
- if credits from global capital markets to refinance liabilities become unavailable or are obtainable only at high costs, and
- if export earnings plunge.

All three "ifs" came to pass for EE during 2008-09 as a result of the global crisis.

Figure 6, which shows 2000-09 trends in the net flow of private capital (mostly FDI) to EE, is self-explanatory.

[*Figure 6 goes about here*]

Figure 6. Net Flows of Private Capital to Eastern Europe, 2000-2009

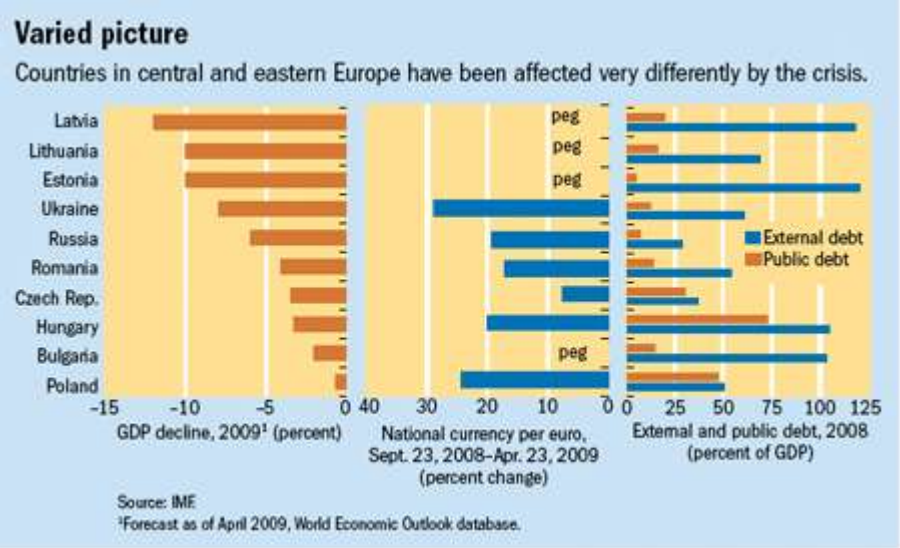


Source: *Financial Times,* May 13, 2009. EE is defined as Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia, Turkey, and Ukraine.

Te exchange rate problem has affected, or threatens to impact, the majority of the EE countries. These problems are the worst for countries with large external (private and public) debt and hence large FC obligations relative to their GDPs, namely, for Latvia, Estonia, Hungary, and Bulgaria, as shown in Figure 7. The extent of the problem is also a function of the level of official reserves (hence the need for IMF-led bailouts) and the proportion of short-term FC obligations in the total.

[*Figure 7 goes about here*]

Figure 7. Estimated GDP Declines in 2009 and 2008 Total External and Public Debts as Percent of GDP in Selected East European Countries



Source: Marek Belka (Director of the IMF's European Department and former Prime Minister and Minister of Finance of Poland), IMF, *Finance and Development*, June 2009. Let us note that since the chart's April 2009 GDP forecasts, the outlook has worsened for most countries; also, that several EE currencies had recovered somewhat between April 23rd and mid-June 2009.

(d) Problematic as the FC indebtedness is for several countries, a number of reputable sources in the West have overstated EE's FC loan problems. For example, one oft-repeated statement during early 2009 was that FC loans in the East are analogous to the subprime loan problems in the West; the implication being that they will cause comparably large losses for their financial institutions and governments. Not so, in the author's view.

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 FC -- were granted mostly to the emerging middle class.

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

In the West, mortgage lending grew rapidly because housing and real estate prices were projected to continue to rise, encouraging speculative borrowing. When the bubble burst, the value of the collateral collapsed and many borrowers walked away. In Hungary, there was no real estate speculation (although in the Baltics and in Ukraine there was), so there is no bubble to burst, at least in Hungary.

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 have remained on the lenders' balance sheets. And the banks are making accommodations to those who are able to pay but are facing hardships due to the plunge in the values of the local currencies.

In the West, household debt to GDP ratios are around 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 about 36%.

For all these reasons, losses and outright defaults on mortgages are, and will remain, relatively lower in Hungary (and probably in the Baltics as well than, for example, in the USA or in the UK.

Finally and importantly, the predominantly foreign ownership of EE's banks serves as a safety net, in part because much of the banks' FC liability is to their parents, and partly because in most cases the parents, and their governments, stand ready to support their subsidiaries, as needed (see note 15).

The lesson (of borrowing and lending in foreign currencies) for those countries that have not formally adopted the euro is that policymakers have a responsibility for measuring and managing the vulnerabilities arising from FC loans in their economies.

V. Impacts, Responses, Outlook, Recommendations

Economic and Social Impacts

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, synchronized recession, that some have labeled, with justification, a depression. The 29 countries of EE -- broadly defined here by including Russia, Ukraine, the three countries of the Caucasus, and the five countries of Central Asia -- have been hit as much as Western Europe, on average.

All of EE has been hit simultaneously – though by varying degrees -- by three interdependent shocks: plunging demand for their exports, dramatic declines in capital inflows, and severe constriction of domestic credit to businesses and households. There is not a country that will avoid a GDP decline in 2009; for several, the estimates are in double digits. Recovery by 2010 is uncertain because so much of its timing and speed depends on external economic conditions.

Certain sectors are hurt much more than GDP. For example, the foreign trade sectors have been slumping much more, with energy, raw material and capital goods exporters suffering more; the first two groups experiencing large terms of trade losses, too. Russia, Ukraine, and Central Asia have much lower trade participation ratios than the rest of EE, which is helpful, were it not for their unusually large terms of trade losses. (In recent weeks, energy prices have started to come back.) The rest of EE's trade has been closely integrated with the economies of Western Europe, which now has its downside, too.

The impact of the global crisis has hurt relatively more those countries whose governments have followed imprudent, irresponsible economic policies during boom times. One measure of relative hurt is the size of the so-called "sovereign spread" (the cost of insurance against default on government debt, expressed in basis points, 100 basis points = 1%); another is the spread on corporate bonds.

For the ten EE members of the EU, one measure of macroeconomic prudence is the degree of compliance with the four Maastricht convergence criteria for euro adoption (discussed above). The ten countries differ substantially on this. Slovenia and Slovakia were clearly in the lead as they have already entered the Eurozone. 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."[35] As a consequence, Hungary is less able to rely on fiscal measures to ease the downturn. Monetary policy easing is also constrained by the need to keep policy rates sufficiently high to have adequate demand for government bonds. As a consequence, its recovery is likely to be delayed and muted (Appendix A has more on Hungary). In all these respects, Slovakia and the Czech Republic have fared considerably better.

To be sure, other factors, such as the size of the current-account deficit, unusually high capital inflows to the banking system (which raises concerns about (1) the host government's contingent liability in case of major banking and other corporate defaults, and (2) the tempo of credit growth and the resulting overheating of the economy) are also at play.[36] It is on these other factors that the Baltic economies had performed poorly, contributing to the spectacular decline of their GDPs (Figure 7) shortly after registering such extraordinarily high growth rates.

Let me offer a personal observation about the population's reaction in EE to the economic decline and growing unemployment being experienced and forecast. Given the sustained rapid rate of growth and improved living standards in just about all the countries of EE during the current decade, until 2008, the financial and economic crisis has come as a shock to most people. Other than reading or hearing the headlines about the unimaginably large losses of US financial institutions, which the media is attributing to capitalism and its companion, greed, there is little general understanding of the global nature of the crisis, the transmission mechanisms at work, and of the huge problems that many other countries are experiencing. The population in EE (if I dare such a broad generalization) believes that their own country's and their own personal economic situations are much worse than elsewhere, so the country is entitled to foreign assistance and disadvantaged households to a fully protective social safety net. And a government that denies this to them, and is taking strong austerity measures, should be replaced by a more "generous" set of politicians.

So partly for the above reason, one impact of the crisis is growing social and political instability in the region. So far the chief protest has been in the voting booths, with surprisingly little violent demonstrations on the streets. For example, the patience with which the Latvians and the Ukrainians have been suffering the punishing economic hardships has been remarkable and a credit to their democratic regimes.

Remedies Attempted and Needed

Turning to **remedies** that have been introduced or still needed, they **can be classified into four types: fiscal measures to mitigate the severity of the economic decline, country-specific financial measures to protect the banking system and to unblock the credit spigot, EU-wide coordination to make sure that policies in one country do not cause unintended hardships in others; and financial assistance to the needy by the IMF and other international financial institutions.**

National fiscal measures are of three types: the quick administration of automatic stabilizers, such as unemployment compensation, to help maintain incomes; introducing fiscal stimulus in those countries where there is room to do so by increasing expenditures and/or reducing taxes; and restructuring the government budget to stimulate long-term economic growth. Additional fiscal stimulus is easier to finance in countries that had hewed to responsible fiscal policies during boom times and that had established sovereign wealth funds, as did several of the Central Asian oil and gas exporting states.

Protecting the banking system and unblocking the flow of credit are complimentary essential preconditions of sustained economic recovery. Credit is the lifeblood of a market-oriented economy, even more so in Europe than in North America, owing to their heavier reliance on loans over equity finance. Prudence, regulation, and investors require that banks and other financial intermediaries extend credit only when they have sufficient deposits, adequate reserves with the central bank, and sufficient equity capital to absorb current and future losses. If banks lose a great deal of money because they made too many high-risk investments in questionable financial instruments or a significant percent of past borrowers are not meeting, or may not in the future meet, debt-service obligations, the financial institution's existing capital base will be impaired, little or no new deposits, loans, and capital can be obtained from the private sector, general trust in the health of financial institutions disappears, and credit offerings will dry up. Essentially this is what happened globally during the last four months of 2008 and early 2009.

Restoring the financial health of a country, especially of its banking system, is essential for three reasons:[37]

- First, without a properly functioning financial system, monetary and fiscal policies will not be as effective as they could be in supporting demand.
- Second, with a wave of losses from the recession still to hit the financial system, there continues to be a significant risk of a further negative feedback loop with the real economy.
- Third, left to their own devices, banks have too many incentives to simply muddle through and remain dependent on continued slow infusion of taxpayer money. Private investors will not step in. This combination is a recipe for continued slow growth.

According to the IMF, as of June 2009 decisive and well-coordinated action is still lacking in the Eurozone to restore financial health in the region. **Appendix C** discusses the complex issue what needs to be done to protect the banking system and to unblock the flow of credit, with brief references o the experiences of selected EE countries.

EU-wide coordination to improve the effectiveness of economic policies region-wide and to prevent adverse, cross-border spillover effects of national economic policies can be likened to a glass that is half full and is therefore also half empty, with the water level rising slowly.

Compared with the almost complete absence of coordination and the pursuit of beggar-thy-neighbor policies in Europe during the Great Depression, the situation is incomparably healthier today. In spite of its imperfections, there is a single market in Europe; even non-EU members have reasonable access to the Common Market. For a large subset of countries there is a common currency and the European Central Bank is doing a good job in pursuing effective monetary policies for its members.

Strongly on the plus side is the widespread recognition by West European governments and regulatory authorities, the EU Commission, decision makers in international financial institutions, and the leaders of large European banks with subsidiaries in EE of the interlinking of West and East European financial systems. The words and deeds of these influential persons is impressive (for illustrations, see note 15). Although self-interest by the West Europeans is a primary incentive for helping their bank subsidiaries in EE; this itself is positive and bodes well for the EE's economic future in as much as the road to further convergence has not been blocked during this major crisis by shortsighted decisions.

The main shortcomings of EU-wide cooperation are, first, that fiscal policy - most notably, taxation – involves little coordination; second, that there is no supranational authority or agreement on the supervision of financial institutions. This reduces the effectiveness of monetary policy and gives rise to unhealthy tax and regulatory competition among the members. Perhaps an agreement can be hammered out in the near future that certain aspects of fiscal policy should be aligned and growth-enhancing structural reforms, such as the age-related increases in public costs looming on the horizon, undertaken in a coordinated fashion.[38] One rationale for fiscal coordination is that the benefits of fiscal expansion spill across borders while its costs (increasing debt levels and potentially higher financing expenses) are locally incurred.

Coordination of financial regulation is needed as well. For example, agreed methodologies to determine capital adequacy and common approaches to deal with impaired assets will avoid distortions and policy arbitrage, and minimize collective costs. Home-host coordination on loss recognition and recapitalization of cross-border banks would also be beneficial.[39]

Financial supervision needs to be made multilateral and partly supranational, as suggested by the February 2009 report of the de Larosier Group. in February 2009. It proposes to establish a European System of Financial Supervisors, bringing together the national supervisors with three independent supranational "Authorities" (for banking, insurance, and securities markets), accountable to the EU institutions. These Authorities would oversee the work of and resolve disputes among national supervisors, who would retain responsibility for supervision. Cross-border institutions would be supervised by colleges of home and host supervisors. To bridge the gap between macro- and microprudential oversight, the group proposes creating a European Systemic Risk Council, linked to the European Central Bank. This council would comprise the Governors of the European System of Central Banks, the heads of the Authorities, and the European Commission. The group advocates the establishment of a truly harmonized set of core roles, harmonized and pre-funded deposit insurance schemes, and more detailed criteria for burden sharing.[40]

External financial assistance to help manage the crisis is particularly important for many countries in EE. Owing to the substantially enlarged resources the April 2009 G-20 meeting of heads of state made available to the IMF, and to the catalytic role the Fund plays in securing co-financing from other international financial institutions and from

governments, the IMF is the key source of external financial assistance to the developing world. Between late 2008 and May 2009, the largest number of countries the IMF helped, and the largest support given, had been to EE, not to Latin America or Asia (Table 2).

Outlook and Recommendations

Concerning the **outlook** and speaking for Europe as a whole, in early June 2009 it appears as if the worst of the decline in economic activity is now over. Since March 2009, the emerging economies' stock markets, including those in EE, have recovered a significant part of their recent losses, which is a favorable signal for EE's medium-term economic future. However, looking at the fundamentals, the timing and the shape of the recovery remain highly uncertain.[41] When the recovery occurs, it is likely to be slow because there is no substitute in sight to replace the sustained excess consumption in the USA, in many West European countries, and in practically all of EE, which during the first eight years of this decade had served as the main engine of rapid globalization and growth. The pace of recovery and of growth thereafter could be speeded up or slowed by the policies implemented to recover or insure the health of the financial sector.

The likely slow recovery and growth of Europe does not bode well for EE, either in the short- or in the medium-run. The economic strategies of the EE countries, which yielded, on balance, impressive growth for about a decade prior to the global crisis, had three pillars:[42] (1) the extraordinarily rapid trade and financial integration into the global, especially the EU, economy, as shown by the fast increase in their foreign trade and financial participation ratios in GDP; (2) large capital inflows that made possible the rapid growth of productivity and improved living standards. The inflows also helped finance large current-account deficits; and (3) appreciating real exchange rates, which contributed to improved living standards and to keeping inflation in check.

The presumed slow recovery and growth of Europe means that EE's past rapid trade and financial integration into the EU will slow considerably. Net capital inflows are likely to be smaller, at least in the medium term. This means that in the future EE must rely more on internally-generated sources of productivity growth and competitiveness. The list and measurement of practically all the important factors of growth can be found, comparatively among more than 100 countries, in the annual Global Competitiveness Reports. Policymakers in EE can readily find the macro, mezzo, and micro (or business environment) factors where their countries lag seriously behind competitors. Improving those, which in many cases would require no large new expenditures, only the political will to address them, can be major, new, domestically-generated sources of enhanced productivity and improved competitiveness.

A general recommendation to USAID is that in each target EE country it should identify, in cooperation with the local authorities, those few factors of competiveness where the country lags behind and do what it can to support the authorities and the private sector to transform competitive disadvantage factors into new sources of productivity and competitiveness.

Appendix A. Hungary: From Leader to Laggard

One interesting and puzzling development in the EE region is why and how Hungary has moved from being a leader of the economic reform and then systemic transformation process, which it was for about the last three decades of the 20th century, to a country whose economic performance and prospects had weakened so much that today it is a laggard among the EE members of the EU.

The short answer has two parts. One, that after 2000 Hungary refused to continue making the essential structural reforms still needed, that is, in the welfare system, pensions, healthcare, and education. Two, successive governments had pursued imprudent fiscal policies, incurring large budget deficits even during boom times, rapidly accumulating a large public debt. Both these problems can be traced to Hungary's highly confrontational and dysfunctional politics.

The main reason for Hungary's large budget deficits is the unusually high share of government expenditures in GDP. Figure A-1 shows government expenditures in 2007 as percent of GDP for each of the 27 member countries of the EU, plotted against per capita GDPs (calculated at purchasing power parity). (*The captions will be translated to English.)*

The regression line shows that in Europe, higher government expenditures as percent of GDP generally rise as countries become richer. Hungary is the most dramatic outlier in the regression. The 50% of GDP that the government of Hungary redistributes is matched only by Europe's three rich countries, Sweden, France, and Denmark. Clearly, Hungary is running a generous welfare state which it cannot afford. Therefore, the government borrows and borrows. To the extent that it borrows in domestic currency, it is crowding out financing from the private sector; to the extent that it borrows from international capital markets, it is accumulating large foreign-currency debt, making the country especially vulnerable during the current global financial and economic crisis. And since a growing share of government revenues must be devoted to debt service, it is placing a burden on future generations, in this way, too, constraining future economic growth.

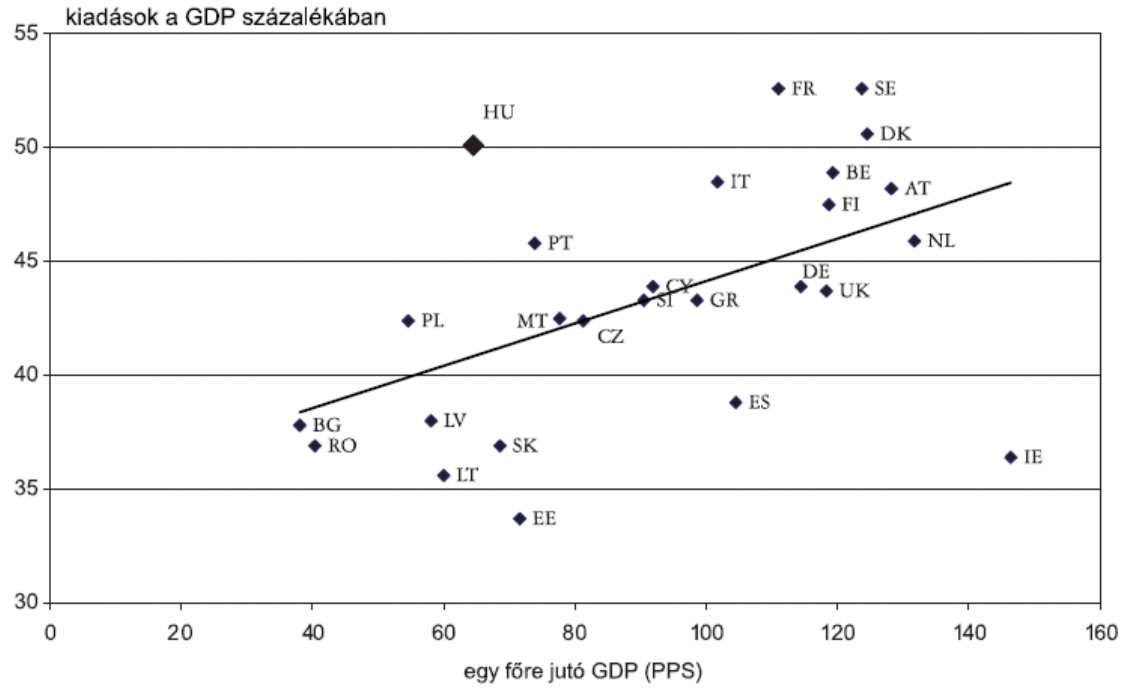
[Figure A-1 goes about here]

Hungary has a notoriously inefficient tax system, with too many taxes and high rates. However, it collects only from limited segments of the population and the business sector. Tax avoidance is a national pastime. And as the government raises businesses and household taxes as a tool of its current austerity, it is making the country less and less competitive vis-à-vis neighboring countries such as Slovakia, the Czech Republic, and Romania that have successfully streamlined their tax systems. These are some of the reasons why Hungary, for decades the leading reforming and transforming country in the region, has been sliding during the current decade. As a result, it has been hurt more by the global crisis than most of its fellow EU members (except for the Baltic states) and its potential for sustained growth after the global crisis has been seriously impaired.

Figure A-1. State Budget Expenditures of EU Members Relative to Levels of Economic Development in 2007
(As percent of GDP)

1. ábra

Az Európai Unió országainak államháztartási kiadásai gazdasági fejlettségük függvényében (2007)



Forrás: Eurostat

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The main lesson that Hungary's experience offers, especially to the countries of the West Balkans, is that the global crisis should not be an excuse, but a spur, to continue making those structural reforms that are needed, and that fiscal and monetary policies must remain prudent.

Appendix B. The Caucasus and Central Asia

This brief appendix highlights a few facts and issues about the **eight countries in the Caucasus and Central Asia.**

An important difference among them is between oil and gas exporters and importers, with four countries in each group, as is shown on the map below.

Caucasus and Central Asia Countries

The CCA region consists of eight former Soviet Union republics. In the north, the region borders on Russia and in the east, on China. Both neighbors are key economic partners for the landlocked CCA region. There are four oil and gas exporters (Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan) and four oil and gas importers (Armenia, Georgia, the Kyrgyz Republic, and Tajikistan). CCA countries differ substantially in terms of per capita GDP, which ranges from $800 in Tajikistan to $8,500 in Kazakhstan.

Source: IMF, *Regional Outlook in the Caucuses and Central Asia* (May 2009).

During 2007-08 hydrocarbon exporters had positive fiscal as well as current account balances and are projected to maintain those during 2009-10, in spite of lower world market prices than in previous years. Hydrocarbon importers had and are expected to continue negative fiscal and current account balances.

Appendix Table B-1 gives the government fiscal balance as percent of GDP, the current account balance, as well as real GDP growth for the 8 countries, covering the period 2000-2010 (2008 data are estimated, 2009-10 data are projected). The IMF concludes that on average, growth in the region will be flat in 2009 after having expanded by 6% in 2008. Falling commodity prices, declining remittances (mainly from Russia) and demand for exports, and the drying up of investment inflows are leading to fiscal and balance of payments pressures and sharp slowdowns in economic activity in the region.[43]

Table B-1. Selected Economic Indicators, Caucasus and Central Asia, 2000-2010

	Average 2000–04	2005	2006	2007	Est. 2008	Proj. 2009	Proj. 2010
			Real GDP Growth				
			(Annual change; in percent)				
CCA	**8.2**	**11.0**	**13.1**	**12.0**	**6.3**	**0.9**	**5.0**
Armenia	10.7	14.0	13.2	13.8	6.8	-5.0	0.0
Azerbaijan	8.3	24.3	30.5	23.4	11.6	2.5	12.3
Georgia	5.8	9.6	9.4	12.4	2.0	1.0	3.0
Kazakhstan	10.4	9.7	10.7	8.9	3.2	-2.0	1.5
Kyrgyz Republic	4.9	-0.2	3.1	8.5	7.6	0.9	2.9
Tajikistan	9.7	6.7	7.0	7.8	7.9	2.0	3.0
Turkmenistan	17.3	13.0	11.4	11.6	9.8	6.9	7.0
Uzbekistan	4.8	7.0	7.3	9.5	9.0	7.0	7.0
			Central Government Fiscal Balance				
			(In percent of GDP)				
CCA	**0.1**	**3.0**	**4.1**	**3.0**	**6.0**	**-1.4**	**1.9**
Armenia	-2.7	-2.0	-2.1	-2.2	-1.7	-3.6	-3.1
Azerbaijan	-0.2	2.6	-0.2	2.8	22.4	-1.5	9.5
Georgia	-1.5	-2.4	-3.0	-4.7	-6.4	-5.6	-5.1
Kazakhstan	1.7	5.8	7.2	4.7	1.1	-2.0	-1.0
Kyrgyz Republic	-6.0	-3.6	-2.1	-0.3	-0.3	-1.9	-4.5
Tajikistan	-3.1	-2.9	1.7	-6.2	-6.1	-7.0	-5.3
Turkmenistan	1.1	0.8	5.3	3.9	11.0	5.2	3.2
Uzbekistan	-1.0	1.2	5.2	5.1	10.2	2.9	5.2
			Current Account Balance				
			(In percent of GDP)				
CCA	**-1.9**	**0.3**	**3.2**	**1.6**	**9.9**	**-0.4**	**4.1**
Armenia	-7.5	-1.0	-1.8	-6.4	-12.6	-11.4	-10.5
Azerbaijan	-14.9	1.3	17.6	28.8	35.5	10.8	18.4
Georgia	-7.3	-10.9	-15.1	-19.6	-22.6	-16.4	-16.7
Kazakhstan	-1.3	-1.8	-2.5	-7.8	5.3	-6.4	1.1
Kyrgyz Republic	-0.6	2.8	-3.1	-0.2	-6.5	-6.3	-8.4
Tajikistan	-3.1	-2.7	-2.8	-11.2	-8.8	-9.7	-8.3
Turkmenistan	4.0	5.1	15.7	15.4	19.6	15.7	9.2
Uzbekistan	3.0	7.7	9.1	7.3	13.6	7.7	6.8

Source: "Global Crisis Bites in the Caucasus and Central Asia," IMF Press Release 9/157, May 10, 2009

Appendix C. Actions to Restore the Health of Country Financial Systems

Restoring the health of a country's financial system and unblocking the flow of credit requires several things.

One, to have a reasonably good estimate of the extent of the cumulative losses that the banking system, and each systemically important financial institution itself, is likely to suffer as a consequence of past and likely future developments in the domestic and global economies. This is what a so-called **"stress test**" is designed to do. This has recently been completed in the US and in several West as well as EE countries (for example, in Hungary), and it is under way in the other West European and EE countries. One problem is that, as of yet, not every country has a comprehensive stress-test program; another, that for those that do, methods differ; still another, that detailed results are not intended to be published, so public and investor confidence remain impaired.

Two, the non-performing loans (NPLs) and other types of **impaired** (or "toxic") **assets must somehow be taken off from the balance sheets of banks**. One way this can be done is by forcing them to write off or to sell those assets, to the government if there are insufficient private buyers; another, to ring-fence impaired assets (for example, by creating a partly or fully government-owned "bad bank" for that purpose) in order to reduce uncertainty. It is my understanding that the main method in EE is to suggest or require the banks to create loss-reserves or otherwise write off their NPLs. In view of precarious financial situation of most EE governments and the fact that so many of the important banks are foreign owned, this approach makes sense and the process is under way.

Three, the authorities must make sure that all **banks have sufficient**, or more than sufficient, **equity capital to be able to make new loans**. There is no scientifically precise way of defining how much capital is "sufficient" relative to the size of risk-weighted assets. Various capital-adequacy measures try to do that. The internationally agreed norm is stated in the Basel-II Agreement.[44] Generally speaking, in times of global turbulence and mistrust, it is advisable to have "more than sufficient" capital (*vide* the last sentence of note 15). In the USA and in Western Europe, the shortfalls in equity capital are being provided by some combination of private sector and government investments in financial institutions; the combination is decided on a case-by-case basis. In most countries, the intention is that the government would eventually sell its partial ownership to private investors. In EE, the additional equity needed is being provided largely by the private sector, in most cases by the foreign parent (who in turn may be recapitalized in part by the government of the home country). I am aware of only a few cases where the government has nationalized banks: One of Latvia's largest bank, Parex, was nationalized in November 2008. In Serbia, through April 2009, only one small bank went into receivership.[45] In Kazakhstan, two large, domestically-owned private banks had been nationalized. In certain E countries, such as in Slovenia, some key banks and other financial institutions are still government owned, having not yet been privatized after the

system change; in those cases it is of course the government that will have to provide any additional equity capital needed.

Four, **monetary policy must be accommodating to encourage bank lending.** Policy rates (the interest rate the central bank charges on loans to banks) should be reduced as much as possible. Reserve requirements (the share of customer deposits that banks are required to keep in their vaults or on deposit with the central bank) are lowered. Treasury bills (short-term), government bonds (longer term), and other high-quality financial assets may be purchased or acquired by the central bank under swap arrangements to increase bank reserves or to lower interest rates. The central bank or the Treasury may offer guarantees on certain types of new loans the banks are making, to encourage lending. The US, the UK, the European Central Bank, and some countries of Western Europe have made extensive use of these policy instruments. The EE countries could do so to a much more limited extent, for a variety of reasons, including the undeveloped nature of their financial systems and instruments in some of the poorer countries. And policy rates have been much stickier owing to the need to defend the exchange rate; in countries with large government debt, to attract buyers for government debt. Some countries have reduced reserve requirements (ex: Hungary); some others may have done it as well. One important problem in EE that neither the US nor the Euroland countries face is banks not having ready access to various foreign currencies, as needed. To ease this problem, central banks in some EE countries have been establishing and giving the banks access to various types of FC swap facilities and have also started to offer guarantees on certain types of bank loans. All and all, in mid-May 2009, the credits in most if not all of the EE countries remain partially blocked by the scarce availability of loanable funds, by the toughened standards of creditworthiness, and by the higher cost of funds to the financial intermediaries as well as to the ultimate borrowers.

Endnotes

[1] 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%.

[2] Harvey Golub, *The Wall Street Journal,* December 9, 2008, p. A17.

[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.)

[5] *The Wall Street Journal*, April 22, 2009. Insurance companies will have $300 billion and other financial institutions an estimated $1.3 trillion of losses.
[6] "German Bad Banks", *Financial Times*, May 12, 2009.
[7] *The Wall Street Journal Europe*, April 22, 2009, p. 31. Thus, while the U.S. and European .financial sectors are roughly of the same size ($26 versus $24 trillion), the USA relies relatively more on equity financing, Europe on bank financing.
[8] On Germany's banking system and the large losses many of its banks have suffered during the current crisis, see Hans Bleuel, "The German Banking System and the Global Financial Crisis: Causes, Developments and Policy Responses." Forschungsberifte des Fachbereichs Wirthschaft der Fachhochschule Dusseldorft, February 28, 2009. Electronic version available at http://ssrn.com/abstract=1365813.
[9] 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 Country Report on Slovenia, No 09/160, May 2009, p. 12.
[10] Zsofia Arvai, et al., "Regional Financial Interlinkages and Financial Contagion Within Europe" (IMF Working Paper 09/6, p. 5.
[11] Data for Slovenia is n.a. in the source; based on partial information in the IMF's Slovenia Country Report 09/160 (May 2009), Part II, Figure 1, the figure is the author's estimate.
[12] Lecture by EBRD President Thomas Mirow at the London School of Economics, March 10, 2009, as reported on EBRD's website.
[13] Let us note that for the past six months GDP forecasts for both parts of Europe have been revised steadily downward, so the 6% should be taken as a ballpark figure, not as a pinpoint estimate
[14] For example, at the end of March 2009, non-performing loans as percent of total loans stood at less than 4% in the Czech Republic and at about 6% in Poland, in both cases representing less than 10% of the banks' equity (Wood and Co consultant's report, April 2009). However, the IMF projects that by the end of 2010, the region's banks could face non-performing loans of about 20% of total loans (*Financial Times*, April 5, 2009), for which they generally have not yet made adequate provisions (IMF, *Regional Economic Outlook for Europe*, May 2009, p. 53).
[15] There could be no stronger evidence of this commitment than the March 26, 2009 meeting of the parents of the nine largest foreign-owned banks in Romania, under the chairmanship of the IMF and with the participation of the World Bank, the European Commission, the European Central Bank, the European Investment Bank, the National Bank of Romania, the home-country banking supervisors and the ministries of finance of Austria, France, Greece, and Italy, after which a statement was released, stating that "all banks in Romania are currently in good financial condition, and that the parent banks of the foreign-owned Romanian banks, with a market share of 70% of assets, have so far behaved responsibly, providing their Romanian affiliates with capital and funding … as the need arose." (IMF, "Financial Sector Coordination Meeting on Romania: Concluding Statement", March 26, 2009.) This gathering was followed up by another meeting on May 19, 2009, by representatives of the same organizations, where it was agreed that the parent banks will submit specific bilateral commitment letters in the coming weeks on "… maintaining their overall exposure to Romania and increasing the capital of their subsidiaries, as needed." It was also agreed to a "… precautionary increase in the minimum capital-adequacy ratio for each subsidiary from 8 to 10% … to help Romania's banking system to weather the current crisis better." (IMF-European Commission Press Release No. 09/178, May 20, 2009). Separately, in the case of Serbia, too, "… the main foreign parent banks have voluntarily committed to roll over their exposures to Serbia and keep their subsidiaries well capitalized." (IMF Press Release No. 09/169, May 15, 2009.)
[16] The "Flexible Credit Line" has been established in early 2009 to allow members with very strong track records to access IMF resources, based on pre-set qualification criteria, to deal with both crisis prevention and crisis resolution situations. Access is determined on a case-by-case basis and is not subject to a predetermined cap.
[17] As of June 5, 2009, 1 USD = SDR 0.6458 (IMF home page).
[18] IMF Press Release No. 09/158 (May 8, 2009).
[19] IMF, *Regional Economic Outlook for Europe*, May 2009, Table 11.
[20] 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 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.

[21] In February 2009 the *tenge* was devalued vis-à-vis the USD, to which it remains pegged. In the short run the IMF views Kazakhstan's pegged exchange rate regime as "appropriate until the problems in the financial sector are resolved; … over the medium-term, we see benefits to allowing greater exchange rate flexibility." (IMF, "Mission Statement", May 15, 2009.) On the exchange rate regimes and policies of the countries of the Caucasus and Central Asia, see IMF, *Regional Outlook for the Caucasus and Central Asia*, May 2009, p. 32). It is worth mentioning that it was only in 2008 that Turkmenistan unified its exchange rates and that at the beginning of 2009 it redenominated its national currency, and introduced other fiscal and banking reforms for which it earned the IMF's praise. (IMF Press Release No -09/164, May 12, 2009.)

[22] Slovenia: IMF Country Report No. 09/160 (April 28, 2009), Part I.

[23] IMF, "Article IV Consultation with the Republic of Slovenia" (May 22, 2009), p. 4.

[24] 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.

[25] *IMF Survey Online,* May 28, 2009.

[26] *Ibid.*

[27] *Ibid.*

[28] "Latvia's Currency Crisis is a Rerun of Argentina's", *Financial Times,* June 10, 2009.

[29] For a cogent argument on why Europe's economy is likely to be stuck at low growth for some time, see Wolfgang Munchau, "Down and Out for the Long Term in Germany," *Financial Times,* June 7, 2009.

[30] World Economic Forum, *The Global Competitiveness Report 2008-2009* (Geneva: 2008).

[31] C. Rosenberg and M. Tirpak, "Determinants of Foreign Currency Borrowing in the New Member States of the EU", IMF Working Paper 08/173 (July 2008), p. 4.

[32] Hungarian weekly, *Narancs,* March 26, 2009.

[33] It has been suggested in the literature that in smaller countries with exchange rate pegs, especially currency-board regimes, the perceived exchange rate risk is relatively small. (IMF Working Paper No. 08/173), p. 5.

[34] C. Rosenberg and M. Tirpak, *op. cit.,* Figure 4.

[35] IMF, *Regional Economic Outlook for Europe,* May 2009, p. 51.

[36] These issues are explored in Chapter 3 of IMF, *Regional Economic Outlook for Europe,* May 2009. Table 11 on p. 46 shows the fulfillment of the countries of the criteria for Euro accession.

[37] *IMF Survey Online,* June 8, 2009.

[38] *Ibid.,* p. vii.

[39] *Ibid.,* p. viii.

[40] *Ibid.,* p. 24.

[41] *Ibid,* p. 1.

[42] S. Fabrizio, D. Leigh, and A. Mody, "The Second Transition: Eastern Europe in Perspective", IMF Working Paper No 09/43 (March 2009).

[43] IMF Press Release No 09/157 (May 10, 2009).

[44] **Basel II** is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II, which was initially published in June 2004 and became effective as of 2008, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face.

[45] IMF, "First Review Under the Stand-By Agreements," April 30, 2009, p. 4.