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The crisis goes East: a stop to transition?

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Abstract

The global crisis has hit severely the Central and Eastern European Countries (CEECs), even though the impact is different from country to country and depends mainly on previous macroeconomic fundamentals.

The 'exit strategy' is anything but easy for CEECs because they will need to adapt to tight external financing constraints and their economic prospects heavily depend on foreign demand (especially from Western Europe).

The Policy Brief provides criteria to assess the impact of the crisis in CEECs. It also points out that reforming processes are slowing down but they have not been reversed. This is a big achievement but it is not enough. Completing the transition to full market economies and redefining the role of the State, rather than minimizing it, will be the best instrument to avoid future shocks. In a nutshell, the completion of their transition is probably the best answer CEECs can give to the crisis.

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A global crisis reaching the region

The international financial crisis brought to the Central and Eastern European Countries (CEECs)[1] the worst recession since the dramatic fall in economic activity that followed the end of the central planning system in the early 1990s. The region's output is expected to fall by over 6 per cent in 2009. The **crisis reached the region coming from abroad, and it took some time to arrive**. Most EU new member states (NMS) still displayed positive and relatively high growth rates in 2008 on a yearly basis. The effects of the financial crisis become clear in the last months of that year, as all CEECs experienced a sharp GDP decline in the last quarter of 2008, that deepened further in the first part of 2009, even if with considerable variation from country to country. Central-Eastern Europe was one of the areas most severely hit by the crisis, and this fact raised some questions not only on the best strategy to exit from the crisis itself, but also on the path followed by these countries in their transition process.

The lag experienced in seeing the effects of the financial crisis are probably due to its origins in the US mortgage and asset markets, to which the CEECs markets were for the most part not directly exposed. Still, the CEECs showed to be highly exposed to other channels through which the financial crisis spread out around the world. **The international crisis was "imported" into the CEECs economies through external demand and foreign lending**. Many of the CEECs' industries rely to a considerable extent on foreign demand, both directly and indirectly, though their participation in international production chains, and this is especially true for the new EU members. As the crisis hit Western Europe and other advanced countries, causing a sharp fall in demand in those areas, this translated in a sharp fall in the CEECs' exports in the last quarter of 2008 (export volumes contracted between 5% and 15%), that became even more severe in the first quarter of 2009, with drops in exports reaching 25%. Furthermore, the growth of the NMS economies since the early phases of transition was fuelled by large inflows of foreign capitals. The financial crisis raised risk perceptions in the international financial markets

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[1] The term CEECs normally includes a large number of countries in Central and Eastern Europe that belonged to the former Soviet bloc or were allies of the USSR, whose economies were centrally planned until the end of the 1980-early 1990s. In this article the specific focus will be on the ten CEECs that became members of the European Union between 2004 and 2007.

and international capital movements slowed down, so that many countries in Central and Eastern Europe saw a sharp drop in the amount of lending available, as capital inflows into the region stopped or in some cases reversed.

The arrival of an economic crisis generated abroad seemed to stress what some political parties in the CEECs always had in their nationalistic agenda: even if integration brought economic growth through strong increase of exports and inflows of capital, it also brought disadvantages, like the heavy dependence on single industries (as in the case of cars in Slovakia) and on Western Europe demand, and a growing stock of external assets and liabilities, via foreign direct investments (FDI) and debt inflows. Therefore, **the crisis raised the issue of the appropriateness of a transition and growth process heavily dependent on economic (both trade and financial) integration**, in particular with the European Union.

Certainly, the growing role of the EU industry and of EU banking groups in the markets of the NMS has rapidly increased the openness and the exposure to external shocks of these countries. It is well-known that especially financial integration can be both a source of stability (for example allowing to finance investments even with a shortage of domestic savings, and thereby fostering growth) or instability (being a channel of contagion in the crisis, and a source of vulnerability, fuelling credit booms, excessive debt, foreign currency lending). But according to some international observers, especially **the political and regulatory integration with the EU has sheltered the NMS from the worst effects of the crisis** and from a meltdown comparable to the experience of some emerging countries in previous crises. There are reasons why the crisis took time to develop in the area and it turned into a severe recession, but not in a dramatic collapse: overall, for most NMS the macroeconomic fundamentals were sound. Moreover, the links created with foreign markets are not as volatile as the ones of many emerging countries: in the CEECs, the structure of foreign capital was a relatively safe one, with large inflows coming in the form of FDI rather than private debt, and the sizeable presence of foreign banks, even if it raised their overall exposure to the fluctuations of the international financial markets, reduced outflows of capital in the trough of the crisis. The more fully financially integrated countries, already belonging to the euro area, were also sheltered from exchange rate fluctuations, dangerous for borrowers exposed in foreign currencies.

A variety of effects and responses

The crisis that hit the CEECs is a global one, and it was not directly caused by domestic problems. But the **extent and effects of the crisis in each country depend largely on the difference in the macro-econonomic situation of the various countries**, and on some of their domestic weaknesses. Estimates on the depth and expected duration of the crisis show in fact considerable variation across countries: double-digit declines in output are forecasted for the Baltic States (Estonia, Latvia, Lithuania) in 2009, and these countries will probably still have a negative output growth in 2010. Also for Hungary the recovery is expected to be slow. Instead Poland is still growing, even if at a much slower rate than in the past years, and it should continue on a similar path also next year. Slovenia and Slovakia registered a sharp downturn in 2009, but they are expected to recover quickly, as world demand picks up, given their strong fundamentals.

These **different performances during the crisis are related to a complex combination of factors**, and not necessarily only to the level of development or the completeness of the transition process. For example, with reference to the largest economies, in spite of some development and transition indicators that rank Hungary higher than Poland[2], the crisis has revealed that the exposure of the two countries to external shocks is quite different, with the Polish economy being the most resilient of the two. Some of these differences can be linked to different policies followed during the transition path, and in most recent years.

The **exposure of each country to the financial crisis and its consequences is related first of all to the amount of external debt contracted and of current account deficits**, possibly added to other sources of macroeconomic instability, such as a pre-crisis credit boom or specific exchange rate regimes.

[2] For example, in 2008, Hungarian income per capita (measured in purchasing power parity) was higher than the Polish one, 15,900 euro and 14,000 euro respectively. This is income gap is quite stable, as it is approximately equal to the one registered between the two in the mid-1990s.

Exchange rates acted as a shock absorber in economies with flexible regimes, while the situation was more difficult for those countries that were pegging their currency to the euro. Among the countries most severely hit by the crisis are those with a high external debt already in 2008, such as Hungary and the Baltic states (close or above 100% of GDP), that made these countries very vulnerable to the problem of credit crunch and con-fidence loss that characterized the international financial crisis. The high financing needs of these countries magnified the impact of the crisis. Instead, Romania's macroeconomic fundamentals were overall good and the growth performance was quite strong in the last years, even if the country experienced a strong increase in private credit in 2007-2008, and it was therefore been hit particularly hard by the drop in capital inflows. Furthermore, Romania (as well as Bulgaria) is still lagging behind in some areas of transition, and it was probably unprepared to face an economic crisis. It has been observed that in general, **countries with a high institutional quality could cope better with the crisis.**

Table 1

	Annual GDP growth rates (%)				
	average 1995-2000	average 2001-2007	2008	2009 (f)	2010 (f)
Bulgaria	-0.1	5.6	6.0	-6.0	-1.1
Czech Rep.	2.2	4.5	2.5	-4.3	0.8
Estonia	6.4	8.1	-3.6	-13.2	-0.1
Latvia	4.8	9.0	-4.6	-16.0	-4.0
Lithuania	3.9	8.1	2.8	-18.4	-3.9
Hungary	4.0	3.7	0.6	-6.5	-0.5
Poland	5.7	4.1	5.0	1.3	1.8
Romania	0.2	6.1	6.2	-8.0	0.5
Slovenia	4.8	4.5	3.5	-7.4	1.3
Slovakia	4.5	6.2	6.4	-5.8	1.9
EU-15	2.8	2.0	0.7	-4.0	0.7

Source: EBRD Transition Report 2009 and EU Commission, DG EcFin Autumn Forecast 2009.

Relatively milder were the effects of the crisis for the Czech Republic, and especially for Poland. In the Czech Republic, credit growth in the last years, although rapid, was consistent with the underlying convergence toward the EU average; the current account deficit remained at readily financeable levels. These strong fundamentals have helped the Czech economy to weather the global financial crisis, although a large loss of output could not be avoided. Like other export-orientated eco-nomies, the Czech economy suffered from the collapse of external demand. While the global crisis affected the Czech economy mainly via the trade channel, the worsening of output prospects, tighter credit conditions and shrinking foreign investment inflows also triggered a sizeable decline of investment. Despite the large shock to the real economy, the financial sector has remained relatively stable, mainly due to prudent regulation, and a strong domestic deposit base.

Also the **dependence on foreign demand is quite different from country to country, changing the overall exposure to external real shocks.** Not surprisingly, Poland, with the largest domestic market in the region, was hit much less severely by the crisis than the smaller and more open economies. With a ratio of exports to GDP of about 40%, the Polish economy is relatively closed compared to its regional peers, which limited the size of the demand shock related to the sharp fall in exports at the turn of the year. Furthermore, the depreciation of the currency (down 41% against the euro over the period August 2008-February 2009) is set to translate into a positive contribution of net exports in 2009. Poland also displayed overall good macro-economic fundamentals: the external position remained sustainable and the economic boom facilitated the reduction of the government deficit to a relatively low level – below 2 % of GDP in 2007. With real GDP growth projected over 1%, Poland is expected to be the only country in the EU to post positive growth in 2009.

Once more, the financial crisis has shown that **the CEECs are more divergent than is often perceived**, in terms of their economic integration with the rest of Europe, of their economic structure and with respect to completing their transition path. These differences will affect also the promptness of their recovery.

An assessment of the perspectives to overcome the crisis

According to the EU Commission, **the rebound in Europe is likely to be slow**. Financial market conditions in the region have improved, but the largely bank-based financial system will take time to fully resume its intermediating role. Tight credit conditions will limit private investment, and rising unemployment will weigh on consumption, even as public support will need to be gradually withdrawn. This **situation could be hard especially for the NMS, who will need to adapt to much tighter external financing constraints, and who are more dependent on demand coming from Western Europe**. Given that cross-border capital flows will likely remain lower for some time, for some countries the effects of the credit crunch will be felt for some more months, and output and employment will not increase for most of 2010. The time and pace of recovery will display considerable variation across countries. Forecasts on growth rates for 2010 are very cautious, as the evolution of the international crisis, with unexpected accelerations, unforeseen contagion effects and relatively quick rebounds, required to revise the forecasted figures a number of times. Even considering this high uncertainty, all observers agree that the recovery will be uneven: some CEECs – notably the Baltics – will continue to contract in 2010, but sizable output gains (higher than for the EU15) are expected elsewhere, notably in Poland.

The pace of recovery is influenced by the strength of the recession at the national level, and by the policy measures adopted. The generally fast improvement of the economic conditions in most CEECs is associated to the exceptional policy measures put in place by the national governments and by international institutions. World-wide, the severity of the crisis led to a coordinated, comprehensive crisis response, that tripled IMF resources to US$750 billion, quadrupled EU balance-of-payment support to €50 billion and brought the G20 countries to increase their capital flows to multilateral development banks. Overall, the availability of such massive support prevented a "twin crises" effect in the CEECs: the drop in output was not accompanied by the meltdown of the financial systems that remained comparatively sound, and led to net capital outflows less sharp than in previous crises and other regions. Support was received especially by the most exposed countries: Hungary, Latvia, and Romania are currently receiving IMF balance of payments support. But also Poland has access to the IMF Flexible Credit Line in order to safeguard market confidence.

Accompanying the measures of international support, **the NMS have implemented mature policy measures**. Macro-economic and financial sector policy responses to the crisis have generally operated along similar principles to those in advanced countries. Populist and nationalistic policy reactions, often observed in emerging market crises in the past, were avoided. To the extent that there have been differences – particularly in the area of fiscal policy, which has generally been tighter than in advanced countries – these reflected greater difficulties in accessing capital markets during the crisis period. The NMS could also avoid recourse to extremely tight monetary and fiscal policies which were often viewed as the price of restoring confidence in past crises, thanks to capital outflows that were generally milder, and fundamentals in the public and financial sectors generally stronger than in past emerging market crises.

In recent months, the pace of contraction has slowed dramatically in much of the region, with investment appetite returning, exports accelerating, and the inventory drawdown moderating. In spite of a number of positive outlooks for the next months, it is important to stress that the road ahead is very uncertain, as **macro-economic vulnerabilities are still high, private credit remains sluggish and unemployment is on the rise**. Most firms will still be in need of continued support from policy stimulus, which might be harder to find in the second phase of the crisis. The strength of the initial macroeconomic policy response has been largely determined by the available policy set, which varied considerably across the region. Expansionary fiscal policy measures were limited to the few countries that had enough fiscal reserves. The use of automatic stabilizers to limit the social impact of the crisis (like in Poland) will lead to larger fiscal deficits, that can increase the countries' exposure to credit shortages.

As Table 2 shows, **in many NMS the crisis has deteriorated the situation of the public finances**, increasing the government deficits and piling up the stock of public debt. Overall, though, in this respect the situation has worsen more in the euro area, where public debt projections are higher than for any of the NMS. In Hungary, for example, the high public debt is expected to increase very moderately in the next few years. More worrying is the situation of Latvia and Lithuania, where the government deficit and debt are forecasted to rise quickly, but the size of the countries is such that repercussions on the rest of the EU economy are very unlikely.

Looking at the real economy, in absence of adverse financial shocks, there are good reasons to think that the CEECs will exit from the crisis sooner than the EU15. As the economic conditions in the EU15 improve and demand picks up, **the competitive advantage of the countries in the area is still a big asset, unaffected by the crisis**. Firms is the NMS are likely to see orders increasing earlier than firms in the rest of Europe thanks to their relatively low costs and their integration with the richer markets. On the contrary, cost-cutting in Western Europe may push even more delocalization toward the East, slowing down the reversal in the employment trend.

Table 2

	General government net lending (+) or net borrowing (-) (% of GDP at market prices)				Cyclically adjusted net lending (+) or net borrowing (-) of general government (% of GDP at market prices)				General government consolidated gross debt (% of GDP at market prices)			
	2008	2009	2010	2011	2008	2009	2010	2011	2008	2009	2010	2011
Bulgaria	1.8	-0.8	-1.2	-0.4	-1.8	-1	0	0.6	14.1	15.1	16.2	15.7
Czech Rep.	-2.0	-6.6	-5.5	-5.7	-4.7	-6.5	-4.8	-5	30	36.5	40.6	44
Estonia	-2.8	-3	-3.2	-3	-5.6	-0.7	-0.2	-0.5	4.6	7.4	10.9	13.2
Latvia	-4.1	-8.8	-12.2	-12.2	-8.4	-7	-9	-8.9	19.5	33.2	48.6	60.4
Lithuania	-3.2	-9.8	-9.2	-9.7	-7.8	-8.2	-6.1	-6.7	15.6	29.9	40.7	49.3
Hungary	-3.7	-4.1	-4.2	-3.9	-5.7	-2.6	-2.3	-3.3	72.9	79.1	79.8	79.1
Poland	-3.7	-6.4	-7.5	-7.6	-5.3	-7.1	-7.7	-7.9	47.2	51.7	57	61.3
Romania	-5.5	-7.8	-6.8	-5.9	-8.9	-7.6	-6	-5.1	13.6	21.8	27.4	31.3
Slovenia	-1.8	-6.3	-7	-6.9	-5.4	-5	-5.2	-4.9	22.5	35.1	42.8	48.2
Slovakia	-2.3	-6.3	-6	-5.5	-5.4	-6.3	-5.6	-4.9	27.7	34.6	39.2	42.7
Euro area (12 countries)	-2.0	-6.4	-6.9	-6.5	-3.4	-5.3	-5.8	-5.8	69.8	78.7	84.6	88.8

Source: European Commission, Economic and Financial Affairs, AMECO database.

Has the economic crisis stopped transition?

The economic crisis dominated the policy agenda in the CEECs, like elsewhere in the world, and unsurprisingly the Transition Report of the European Bank for Re-construction and Development in November 2009 underlines that **the pace**

of reforms in all transition countries has slowed down during the past year. Many reforms imply some short-term adjustment costs to obtain long-term benefits (for example though privatization and restructuring processes), and in a period of economic difficulty it is very hard to impose the additional adjustment costs to the population and to the economic system. Still, so far **slowing-down the reforming process did not mean reversing it, and this is an important achievement**, especially for those countries in the region that have not yet completed their transition. Most of the new members of the EU are often no longer considered transition countries, but some of them (notably Bulgaria and Romania, but not only) have not acquired the institutional quality and the market comprehensiveness (for example in the financial markets) of a full-fledge market economy. In some cases, these weaknesses were the exacerbating factors of the crisis. Especially in these countries, if the crisis had stopped or reversed the transition, this could be one of the worse far-reaching effects. This risk has been avoided, and instead the crisis in many NMSs demonstrated their commitment to the market system and economic integration with the rest of Europe.

Completing the transition is the best instrument to get protection from future shocks. A stronger economy can in fact cope much better with the negative consequences of a recession, and it can put in place better policy measures. Some evidence of this comes from the countries that already joined the European Monetary Union and adopted the euro as their currency, Slovenia and Slovakia. These countries were also severely hit by the crisis, but they are expected to stay in recession for a much shorter period of time than most other countries in the area. The experience of Slovenia and Slovakia hints to the advantages of strong macroeconomic fundamentals and economic integration, for example by reducing the bias towards foreign currency lending. These results can be achieved by other NMS also prior to fully monetary integration by an effective regulation.

The transition process for many of the CEECs meant the substitution of the state with the markets. This crisis has underlined the need to redefine, rather than to minimize, the role of state, as **markets need supportive macroeconomic policies, good regulations and high quality of the state and private institutions**. Therefore, the lesson learnt by the CEECs from the crisis could be how to better complete their transition.

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