BertelsmannStiftung

spotlight europe

2010/04 – April 2010

The Economic Crisis in Central and Eastern Europe

Cornelius Ochmann
Bertelsmann Stiftung, Cornelius.Ochmann@bertelsmann-stiftung.de

The "Greek sickness" and the parlous financial situation of the southern EU member states have prompted suggestions that the EU has reached the end of its tether. Such arguments increasingly assign an important role to the purported differences between the various European cultures, and contrast the undisciplined and profligate south with the reform-oriented and frugal Germanic north. How does the new flexible and Slav-dominated east of Europe fit into this scheme?

I

The Process of EU Eastern Enlargement

On 1 May 2004 eight central and eastern European states, Malta and Cyprus joined the EU. Their accession was proceeded by a reform process for which there was no parallel in the history of the European Union. After the collapse of the Soviet empire all the states of central and eastern Europe had to introduce political and economic reforms within a very short space of time. There were democratic elections, and the Communist parties were ousted. At the same time the democratically elected governments initiated economic reforms which, in the period between 1989 and 2004, led to the rise of market economies. In the majority of cases the liberalization of the economy went far beyond the status quo that existed in west European states. A growing distaste for reform in central and eastern Europe meant that 2004 was the latest possible moment for the accession of these transformation states.

There were no precedents for eastern enlargement in the history of the European Union. All previous enlargements had been numerically smaller and the economic power of the new member states had been in line with the EU average. For this reason the economic disparities between the old and new EU member

states were impossible to overlook in 2004, and (in the shape of the Copenhagen criteria) played an important role from the start of the enlargement process in 1993. The opponents of EU enlargement considered this to be a problem and were of the opinion that it constituted an exclusion criterion.

It is now generally agreed that the accession of the central and eastern European states was a complete success. Recent data indicate that both from a political and an economic point of view these states are well on the way to reaching the EU average in the course of the next decade.

II

The EU Financial and Economic Crisis

The financial crisis which began with the bankruptcy of Lehman Brothers in September 2008 spread quickly to the new EU member states. For the first time since the demise of communism and the collapse of the Soviet Union, the central and eastern European states were dragged into financial and economic turmoil that was certainly not of their making. Hungary, which, on account of its deferred reforms, had had to contend with considerable deficits even before 2008, and all the other new EU member states were severely affected. Paradoxically, politicians in these countries had been selling the idea of EU membership as an insurance policy against hard economic times to their electorates for years. As the American financial problems worsened and spilled over into Europe, Asia and South America, they increasingly affected the markets in central and eastern Europe. The stock exchanges in Prague, Budapest and Warsaw were like seismographs. The extent to which the individual economies in central and eastern Europe have become internationalized became clearly apparent. The crisis affected those countries in particular which had problems with their national budgets, possessed low foreign currency reserves, had high levels of debt and current account deficits, or were financing private and public consumption with euro loans.

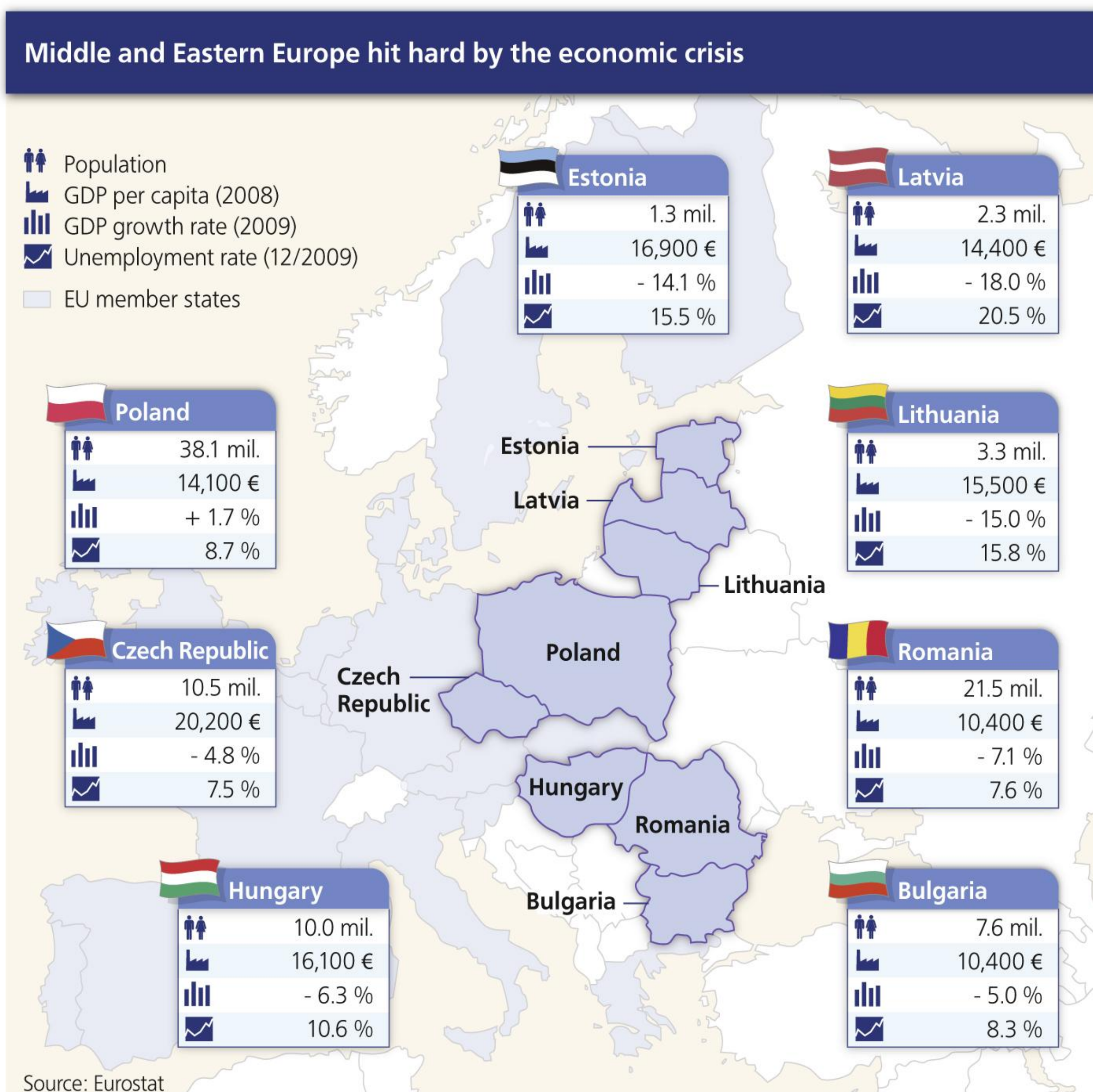
The events in Hungary had ramifications for all of the central and eastern European states. Investors and west European banks fled panic-stricken from the new EU states which did not as yet belong to the eurozone. The crisis in Hungary had begun early in 2008 when the government was no longer able to borrow money on the international markets. With the help of the EU and the International Monetary Fund (IMF) it subsequently managed to put together a reform package which has helped the country to cope with the consequences of the international economic crisis.

Hungary felt the financial crisis more keenly than the other large countries of central and eastern Europe. The duration of the current standby credit agreement with the IMF has been prolonged to October 2010. However, as a result of the reforms it has introduced, Hungary had the smallest budget deficit in the region in 2010 (amounting to about 4 percent of GDP). Stagnation or low levels of real GDP growth are expected in 2010. The newly elected Orban government has not as yet made any specific announcements on when the country intends to introduce the euro.

The economic crisis hit the Baltic republics even harder. They had been compelled to give up the Soviet economic system, and had liberalized their economies and above all their financial markets in a radical manner. Foreign banks rushed into the small and reform-minded states. This turned out to be their downfall in the crisis, for the parent companies had been adversely affected by speculating in the financial markets. In central and eastern Europe the classical banking system was predominant, and it

was under no pressure to become involved in speculation. However, in the crisis the subsidiaries of international banks in the new EU member states were pummelled. This meant that those countries which had welcomed foreign investment in the banking sector were faced with above-average losses. In all of the Baltic republics the gross domestic product (GDP) decreased by double-digit

Bulgaria and Romania, which had both joined the EU only in 2007, were hit hard by the crisis. In 2009 Bulgaria went through its first recession since 1997. After an increase in gross domestic product (GDP) amounting to about 6 percent in real terms in 2008, the economy contracted by 5 percent in 2009. Yet here again there are signs that a recovery is under way. The crisis peaked



© Bertelsmann Stiftung

percentage points. The governments had to implement austerity programmes, and these led to social tensions. However, post-Soviet societies are adaptable and long-suffering. Thus at the beginning of 2010 it was possible to discern nascent signs of economic recovery.

in the first quarter of 2010. However, the forecasts for 2010 as a whole vary. Whereas "The Economist" is already predicting modest GDP growth amounting to 0.6 percent, the Bulgarian government and the International Monetary Fund (IMF) believe there will be a decrease of 2.0 or

2.5 percent. The experts agree that in the medium term the Bulgarian economy will again see above-average growth rates on account of the enormous backlog.

In Romania the crisis reached similar dimensions. After economic growth amounting to 7.3 percent in 2008, economic performance slumped by 7.1 percent the following year. In May 2009 Romania received support for its economy in the shape of a large-scale financial aid package (€20 billion) from IMF, EU, World Bank and the EBRD. The lines of credit are tied to a comprehensive package of measures which include several commitments such as to limit the budget deficit, to contain inflation and to reduce the financial requirements of public budgets. There is once again expected to be very modest growth in 2010 (1 to 1.5 percent).

In the Czech Republic, which had previously gone from success to success, the economic crisis led to a record level of debt in 2009. The budget deficit reached 5.93 percent of the gross domestic product (GDP), which is almost twice as high as is permitted by the EU stability pact. After average growth rates of more than six percent in recent years, the Czech Republic experienced a decrease in GDP amounting to 4.8 percent (2008 had seen 2.5 percent growth) as a result of the worldwide financial and economic crisis. The Czech Finance Ministry is expecting growth of 1.3 percent in 2010. However, it should be pointed out that in per capita GDP terms the Czech Republic has already reached 82 percent of the EU average, and will close the gap by 2012-13. In the Czech Republic the economic crisis has had a significant impact on the labour market. Unemployment doubled to 7.5 percent by the end of 2009.

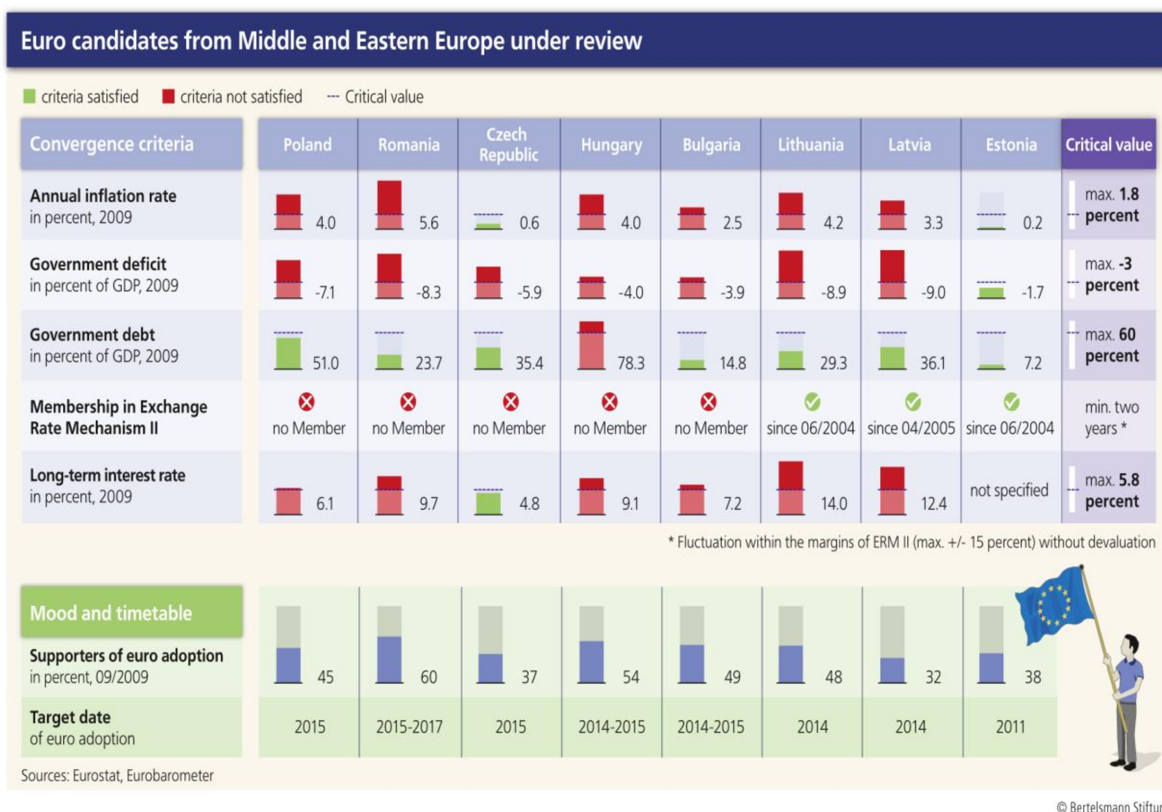
In 2009 Poland was the only country in the EU with positive economic growth amounting to 1.7 percent of GDP. The state of the Polish economy is impressive, although even Poland is feeling the fallout from the crisis. Unemployment is once again on the rise, inflation has increased and the national budget deficit has exceeded the Maastricht 3 percent criterion. The fact that the Polish economy has managed to weather the storm fairly well is primarily the result of its structure and its efficiency. The large Polish internal market, the internal backlog and demand for industrial products, construction materials and consumer goods were able to compensate for the decline in exports. On account of its large internal market Poland's dependence on exports is less pronounced than that of Hungary or the Czech Republic. Furthermore, the Polish economy is flexible enough in order to serve the markets of eastern Europe. Polish foreign currency debt was not on the scale reached in Hungary or the Baltic republics. On top of this there is the stability of the banking sector, which was not affected by speculative deal-making. This year the experts once again expect to see positive economic growth amounting to 3 or 4 percent of GDP.

III

Is the Euro a Stability Factor?

Hitherto two central and eastern European states have managed to become members of the eurozone, Slovenia in 2007 and Slovakia in 2009. Lithuania was for a time treated as a euro candidate, but did not manage to gain admittance in 2007. At first sight only the euro-countries Slovenia and Slovakia seem not to have been affected by exchange rate fluctuations and capital flight. In both countries the advantages of a stable currency predominated at the start of the crisis. For a time all the currencies in central and eastern Europe lost up to 20 percent in value. For example, in the summer of 2008 the Polish zloty plunged within six months from 3.35 to 4.88 compared to the euro. The instability of the exchange rates had a decidedly negative effect on the economies of the region.

Both Slovenia and Slovakia were protected against these uncertainties and notched up moderate economic growth at the beginning of 2009. However, in the course of the year it became apparent that the central and eastern European states whose central banks were able to react to the crisis by devaluing their currencies were actually more flexible. The economies of Hungary, the Czech Republic and above all Poland made much better progress than those of the eurozone newcomers Slovenia and Slovakia. The opponents of eurozone membership acquired new arguments. Vaclav Klaus, the President of the Czech Republic, quipped that "the Czech Republic might adopt the euro in 2017–the hundredth anniversary of the 'Great Socialist October Revolution' in Russia in 1917. If I wanted to be even more provocative, then, in addition to telling you this, I would be tempted to ask whether the euro will still be in existence then (2017)."



Euro candidates from Middle and Eastern Europe under review

criteria satisfied / criteria not satisfied / Critical value

Convergence criteria	Poland	Romania	Czech Republic	Hungary	Bulgaria	Lithuania	Latvia	Estonia	Critical value
Annual inflation rate in percent, 2009	4.0	5.6	0.6	4.0	2.5	4.2	3.3	0.2	max. 1.8 percent
Government deficit in percent of GDP, 2009	-7.1	-8.3	-5.9	-4.0	-3.9	-8.9	-9.0	-1.7	max. -3 percent
Government debt in percent of GDP, 2009	51.0	23.7	35.4	78.3	14.8	29.3	36.1	7.2	max. 60 percent
Membership in Exchange Rate Mechanism II	no Member	no Member	no Member	no Member	no Member	since 06/2004	since 04/2005	since 06/2004	min. two years *
Long-term interest rate in percent, 2009	6.1	9.7	4.8	9.1	7.2	14.0	12.4	not specified	max. 5.8 percent

* Fluctuation within the margins of ERM II (max. +/- 15 percent) without devaluation

Mood and timetable	Poland	Romania	Czech Republic	Hungary	Bulgaria	Lithuania	Latvia	Estonia
Supporters of euro adoption in percent, 09/2009	45	60	37	54	49	48	32	38
Target date of euro adoption	2015	2015-2017	2015	2014-2015	2014-2015	2014	2014	2011

Sources: Eurostat, Eurobarometer

© Bertelsmann Stiftung

Estonia is expected to become the next member of the eurozone. In April President Ilves pointed to the economic indicators, which are in compliance with the Maastricht criteria. "We have a 1.7 percent budget deficit – who else can say that, with the possible exception of Luxembourg. Our public budgets are well on seven percent in the red." And inflation in Estonia was also low enough to secure eurozone membership. Thus there is no reason why the EU Commission should not give the go-ahead.

In **Latvia** membership of the eurozone has receded into the distance as a result of the economic and financial crisis. The national budget is in a parlous state, and Latvia has had to ask the International Monetary Fund for help. A new target date for membership is 1 January 2014.

Lithuania had hoped to introduce the euro in 2007. However, the EU Commission rejected its application for membership on account of its inflation rate, which was 0.06 percentage points too high. Experts are still very much divided on whether or not this was the right decision. In the

following years the inflation rate continued to rise, and to this day Lithuania has not been able to join the eurozone. In the wake of Latvia's announcement that it intends to introduce the euro at the beginning of 2014, Lithuania has made it known unofficially that it is thinking in terms of the same date.

As the crisis developed **Bulgaria** initially profited from the fact that its exchange rate was fixed to the euro in the framework of a Currency Board system, whereas other countries of the region such as Serbia, Hungary and Romania had to bear the brunt of substantial devaluations. Bulgaria intended to join the European Exchange Rate Mechanism in the middle of 2010 and to introduce the euro in 2013. However, in the aftermath of the Greek financial crisis Sofia "recalculated" its budget, and it became apparent that the budget deficit was 3.9 percent, and not 1.9 percent. "In so many words, we lied to our colleagues (in Brussels) by telling them that we were ready for the eurozone," Prime Minister Borissov admitted. Bulgaria has already told Brussels about the real size of its budget deficit. This is going to delay Bulgaria's membership of the European Exchange Rate Mechanism and the eurozone by at least a year. It will not materialize before 2014 at the earliest.

Romania will probably defer its goal of joining the eurozone in 2015 by a year or two. This is deemed to be necessary because the criteria have not as yet been met. However, 2015 continues to be the target date named by the government. In the economic crisis Romania went from being the fastest growing economy in the EU in 2008 to becoming a basket case. The country is currently dependent on international credits amounting to €20 billion, €12.9 billion of which has been made available by the IMF, €5 billion by the EU Commission and another €1.5 billion by the World Bank.

On account of the euro-critical stance adopted by President Vaclav Klaus, there has not as yet been a serious debate in the **Czech Republic** about joining the eurozone. Furthermore, the majority of Czechs are sceptical about the euro. For a long time the Czech parties lacked the political will to tackle the issue, and currently there is insufficient economic room for manoeuvre. Admittedly, the caretaker government under Prime Minister Jan Fischer wants to adopt the euro as quickly as possible, but this does not seem feasible before 2015. The introduction of the euro will to all extents and purposes be determined by the new government elected in May. It must first of all stabilize the national finances, and this will entail reforms which the majority of the electorate will dislike.

On the other hand, **Poland** initially had plans to introduce the euro to coincide with Euro-2012, the European Football Championship. However, in the course of 2009 the situation changed. The devaluation of the Polish zloty made Polish exports cheaper and the economy continued to grow. For this reason the Polish Central Bank decided to defer membership of the euro to 2014.

The lack of a common European response to the economic and financial crisis and, last but not least, the EU's strategy towards Greece has created the impression among the new EU member states that the EU is unable to deal with crises. For this reason it is hardly surprising that for the time being the political and economic elites in countries such as Hungary, Poland and the Czech Republic want to defer membership of the eurozone.

IV

Consequences for the EU

The EU is going through a difficult phase. But the central and eastern European member states are in many cases coping with the economic crisis far better than the "older" member states.

On the one hand they have learnt a great deal in all areas in the course of the last twenty years from the transformation processes. Political, economic and social reforms are neither new nor unusual. Furthermore, the societies in these countries are far more resilient and adaptable than the sated societies of EU 15. For this reason the new member states (with the exception of Romania) have strengthened the disciplined and reform-oriented group and in this respect belong to the "north." Bulgaria, which borders on Greece, can serve as an example to the other south European states.

The responsibility for the current EU crisis should thus be sought in Brussels and the capitals of the largest EU member states. In many cases criticism levelled at the unequal treatment of the new and old EU member states is entirely justified. If the EU Commission had devoted the same care and precision to its analysis of the budgets of the Mediterranean EU states that it evinced in the case of the new EU member states, then there would never have been a PIGS crisis (Portugal, Italy, Greece, Spain). The EU Commission treated identical transgressions in different ways. Whereas in the middle of 2008 Hungary had to introduce far-reaching reforms as a result of a great deal of pressure from Brussels, Greece was able to gain admittance to the eurozone and to defer long overdue reforms with the help of falsified statistics.

The EU finds it difficult to develop a common crisis strategy and an overall economic strategy. The differing concepts for combating the economic crisis, which in 2009 became especially apparent in the case of Germany and France, together with the absence of Italy on the European stage and the self-centredness of the British, increase the danger of inertia.

The introduction of the common currency was a political project. The euro has had a more profound influence on the EU in recent years than any other political decision. The common currency was also supposed to promote solidarity between the rich and the poor. Today not much of this is still in evidence. On top of this there is a design fault within the monetary union, which does not have a sanctions mechanism which can be applied against those who break the rules. In 2009 only Finland was in compliance with the euro criteria. All the other euro states, including Germany, were unable to reach this target. However, there are no mechanisms to enforce compliance. It seems paradoxical that the indicators in states which wish to join the eurozone, such as Bulgaria, Estonia, Lithuania and Poland, are better than those of the eurozone states.

However, the crisis also constitutes an opportunity for renewal and amelioration. The first lesson must be that the eastern enlargement has enriched the EU, and that permitting the new member states to join the eurozone in the near future would strengthen the euro and thus the EU. How can we justify the fact that eurozone candidates are being asked to comply with criteria that most of the eurozone member states have chosen to disregard? In the midst of a crisis and on the basis of ten years of practical experience, it is time to bring the accession criteria into line with the realities. The common currency has stabilized the EU in the midst of the turmoil. However, it has also become clear that there is a need for a reform of the financial and economic structures. More financial discipline and European solidarity cannot be attained without a greater coordination of economic policies. Those who continue to oppose this are simply weakening the EU. Furthermore, there needs to be a sanctions mechanism. And finally, thinking about a European economic government must not be allowed to remain a taboo.

For Further Reading:

World Bank Group (Ed.): Lights Out?: Challenges Facing the Emerging Economies of Eastern Europe and the Former Soviet Union, World Bank Publication, 2010

Vladimir Gligorov, Gábor Hunya, Josef Pöschl et al.: Differentiated impact of the global crisis, Wien (WIIW),WIIW current analyses and forecasts; 3/2009

Vladimir Gligorov, Josef Pöschl, Sándor Richter et al.: Where have all the shooting stars gone?, Wien (WIIW), WIIW current analyses and forecasts; 4 /2009

Zsolt Darvas: The impact of the crisis on budget policy in Central and Eastern Europe, Bruegel working paper; 2009/5

Ognian N. Hishow: Die Finanzsysteme der neuen EU-Mitgliedstaaten im Zeichen der weltweiten Krise, Berlin, SWP-Studie, 2009

Béla Galgóczi: Central eastern Europe five years after enlargement : in full grip of the crisis, South-East Europe review for labour and social affairs, Baden-Baden, Nomos-Verlag, Bd. 12.2009

Reinhold Vetter: Turbulenzen und Konsequenzen.Importierte Wirtschaftskrise in Ostmitteleuropa, Osteuropa 12 /2008

Responsible

Bertelsmann Stiftung
Carl Bertelsmann Straße 256
D-33311 Gütersloh
www.bertelsmann-stiftung.de/spotlight

Dr. Dominik Hierlemann
dominik.hierlemann@bertelsmann-stiftung.de
Telefon +49 5241 81 81537

Joachim Fritz-Vannahme
joachim.vannahme@bertelsmann-stiftung.de
Telefon +49 5241 81 8142

ISSN 1865-7443

Latest editions:

spotlight europe # 2010/03
Elections in Iraq: The impact on U.S.-EU cooperation
Laurie Dundon, Christian Peter Hanelt

spotlight europe # 2010/02
Lisbon – A Second Shot
Joachim Fritz-Vannahme, Armando García Schmidt, Dominik Hierlemann, Robert Vehrkamp

spotlight europe # 2010/01
Cooperation with the Kremlin
Cortnie Shupe

All editions of the spotlight europe can be downloaded from: www.bertelsmann-stiftung.de/spotlight