Council *for*
European
Studies

Perspectives on Europe

An elusive region: East-Central Europe in the crisis

Dorothee Bohle, Central European University*

Analyzing the fallout of the global financial crisis in the EU's new member states has become an expanding cottage industry. Nevertheless, making sense of the calamity, let alone predicting its future impact, remains a daunting task. In light of the complexity and diversity of the still unfolding processes, it is not surprising that East Europeanists, as attested by their fast-changing and often contradictory interpretations, have shared the prevailing bewilderment of many citizens around the globe. The region has stayed elusive in three respects: First, there has been no consensus about how badly it has been hit. Rather, assessments have varied widely over time. Second, there is increasing doubt about whether it makes sense to speak of East-Central Europe as one single region that shares similar problems and experiences. Countries' exposure to the crisis and their capacity to cope with its consequences has differed significantly. Finally, the economic crisis has combined with political instability in some cases but not in others: a development that defies simplistic notions of political consequences of economic woes.

Autumn 2011
Volume 41
Issue 2

How bad has it been?

To date, three remarkably different economic interpretations – one optimistic, one pessimistic and a third pointing to intra-regional diversity – have been offered on the impact of the global crisis in the new EU member states. Initially, optimism prevailed. The decade of vigorous growth preceding the downturn instilled hopes in many observers in the new order's stability. Despite sporadic early warnings that in some cases the prosperity reflected economic

*Author may be contacted at bohled@ceu.hu.

overheating that could lead to crash landing (e.g., World Bank 2007), many observers expected that the region would by and large be immune to the global meltdown. In support of this view analysts pointed out that, notwithstanding the fact that the East-Central European financial sector was dominantly owned by Western banks, these were still relatively underdeveloped and conservative, and thus refrained from risky investments in toxic assets. In the above-cited report, for instance, even the World Bank concluded that although there were imbalances, the region's financial systems were fairly robust. The confidence in future prospects was also underpinned by the belief that due to their rich experiences with recurrent crises in the 1990s and obligations to meet the EU's entry requirements in the early 2000s, these countries had already developed the regulations and institutions that were going to help them withstand even large external shocks.

The downside of the surge in foreign credits that made the economic prosperity of the 2000s possible was the accumulation of macroeconomic imbalances, most notably skyrocketing current account deficits and a rapid rise in external debt.

Things, however, turned out otherwise. It is true that the crisis spread to East-Central Europe with a delay. But once it struck, its impact was severe. To defend their currencies and keep their economies afloat, three countries – Hungary, Latvia and Romania – had to turn for help to the IMF and EU. During 2008–09, all economies, with the exception of Poland, have gone through steep recessions (see table 1). As if to make up for the earlier optimism, some observers started to react by outbidding one another in skeptical assessments of the new market economies. Put most bluntly: "In light of the current global economic crisis the whole process of economic transition appears to be a failure." (Hölscher 2009, 10; see also the essays in Dale 2011). Even if other assessments are less negative, in an ironic change of perspective some of the very factors previously considered as bulwarks against the crisis were since often blamed for the region's problems. Importantly, the outbreak of the crisis gave credibility to the criticism that the combined effects of capital liberalization, financial systems dominated by foreign banks, pegged exchange rate regimes and attempted compliance with the eurozone entry criteria have practically disabled many of the region's governments to protect their economies against the major credit boom prior to the crisis. The same factors, it was argued, also deprived these governments of policy instruments to respond effectively once the crisis broke out. Foreign bank ownership in particular was now perceived as a risk factor, since it has been unclear whether the subsidiaries' huge loan books in the East were going to be covered by their home countries' bailout plans (e.g., Pistor 2009).

The downside of the surge in foreign credits that made the economic prosperity of the 2000s possible was the accumulation of macroeconomic imbalances, most notably skyrocketing current account deficits and a rapid rise in external debt. Other shortcomings included meager fiscal revenues and poor governance, resulting in some cases in the explosion of budget deficits (see table 1). Hence the reason for Jens Hölscher's pessimism that the "overriding problem will be fiscal constraint, which has restricted growth in the past and is now leading the region into deeper recession than the rest of the world." (Hölscher 2009, 14).

In the meantime, however, the pendulum of contradictory narratives has swung back to cautious optimism. Two reasons account for this: First, a full-fledged banking crisis in East-Central Europe could so far be avoided. This is mostly

due to the mediation efforts and emergency plans of international financial institutions. The so-called European Bank Coordination "Vienna" Initiative (EBCI) provided a framework for the crisis management of international banks engaged in the region, home and host country governments and regulators. Accordingly, as suggested by Paul Marer (2010), "the predominant foreign ownership of EE's [Eastern Europe, D.B] banks is turning out to be, on balance, an advantage." This claim is also supported by the fact that the few remaining domestically owned banks were much more vulnerable to the crisis than their foreign-owned counterparts.

Perhaps even more important, the difficulties the East is currently facing pale in comparison to those of Ireland or Mediterranean Europe, where the specters of protracted banking crises and sovereign default loom large. Questioning on these grounds the idea of the newcomers' disproportionate exposure and hardship, in early 2010 *The Economist* (January 9, 2010, 27) contended that, "the continent's biggest financial upheaval is in Iceland … and the biggest forecast budget deficits in the European Union next year will not be in some basket-cases from the ex-communist 'east' but in Britain and in Greece … None of the ten 'eastern' countries that joined the EU is in so bad a mess." If anything, the new EU members' public sector deficits look small in comparison, while their sustained attempts at implementing fiscal austerity are now being advertised as role models for the 'old' European periphery to follow (e.g., Aslund 2010).

Varieties of crisis exposure

To make matters more complicated, the impact of the crisis has not only varied over time, but also across countries. While virtually all countries

Table 1: Selected Economic Indicators, 2007–2009

Country	Real GDP growth (%) 2009	Current account balance (% of GDP, 2007)	External debt (% of GDP, 2007)	Change in credit per GDP (2004–2007)	FX-denominated credit to household (% of commercial bank loans, 2008)	Government deficit (% of GDP 2007 / 2009)	Public sector debt (% of GDP, 2007 / 2009)
Central European Cluster							
Czech Republic	- 4.1	- 2.6	44.4	20	0.1	- 0.7 / - 5.8	27.9 / 34.4
Poland	+ 1.7	- 2.8	54.8	17	39.8	- 1.9 / - 7.3	45.0 / 50.9
Slovak Republic	- 4.8	- 4.8	52.7	17	2.8	- 1.8 / - 8.0	27.8 / 41.0
Slovenia	- 8.1	- 4.8	100.6	30	N/A	0 / - 6.1	23.1 / 35.3
Baltic/Balkan Cluster							
Estonia	- 13.9	- 17.8	119.3	33	82.4	2.4 / - 2.0	4.5 / 6.7
Latvia	- 18.0	- 22.3	135.4	37	87.4	- 0.4 / - 9.7	9.0 / 36.7
Lithu-ania	- 14.7	- 14.5	76.9	30	61.6	- 1 / - 9.5	16.8 / 29.4
Bulgaria	- 4.9	- 25.4	107.6	30	29.8	1.2 / - 4.3	17.2 / 14.6
Romania	- 7.1	- 14.1	48.5	20	58.7	- 2.9 / - 9	12.8 / 23.6
Outlier							
Hungary	- 6.7	- 6.9	96.8	17	70.2	- 5.1 / - 4.6	67.0 / 79.7

Sources: Columns 1, 2, 3: EBRD Transition Report; Column 4: Becker et al. 2010; Column 5: National Bank of Hungary; Column 6, 7: Eurostat.

have experienced rapid credit expansion and accumulated major macroeconomic imbalances prior to the crisis, there are important differences in how much they gave in to the processes of financialization, that is, growth based on credit; and how capable they have been in controlling public expenses. Two major clusters can be distinguished (see also Becker et al. 2010; Becker and Jäger 2010; Myant and Drahokoupil 2010). Table 1 below summarizes the different exposure to the crisis.

The Central European countries Slovakia, Poland and the Czech Republic relied to a lesser degree on credit growth, and were also able to create a competitive export basis that covered an important share of their import needs. The latter is also true for Slovenia. These countries were therefore less affected by the credit crunch. However, as their international integration has primarily been based on (dependent) export-oriented industrialization, the breakdown of their major export markets has left their economies in limbo. While a too hard landing of these countries has to date been prevented by the relatively quick recovery of the German market, another vulnerability has since come to the fore. This is their – in a regional comparison – relatively lavish public finances. In contrast to their Baltic and South European neighbors, these countries have all afforded relatively generous welfare states in the past. Although they have been quite successful in reining in their public finance prior to the crisis, since 2008 these have started to significantly deteriorate again. As a result, governments in Central Europe feel increasingly under pressure to join the austerity wave that is currently sweeping through the eurozone.

In contrast, especially in the Baltic States, and to a lesser extent in Bulgaria and Romania, the growth of the past decade has relied almost entirely on credit-financed domestic consumption, fueled by high investment in the construction and real estate sectors. In these countries, the credit and mortgage booms served as a substitute for their very meager welfare states. The Baltic States in particular had never bothered much with offering their population social compensation for the economic hardship of transition. This is even more remarkable because these countries had embarked on the most radical reform policies, causing huge social dislocation. Initially, governments in the Baltic States relied on identity politics to legitimate radical transition. Radical reforms were deemed necessary to achieve the goal of national independence. Identity politics, however, lost much of its appeal during the 1990s. Against this background, the reliance on private credits to secure income and employment offered the Baltic governments an institutional device, which allowed addressing rising social discontent while also being compatible with their market radical orientation. In all three Baltic countries, aggressively expanding banks colluded with governments to set off housing booms that by far exceeded those of neighboring countries east and west. High credit-financed growth led to unprecedented levels of current account deficits and external debt. The global credit crunch has impacted hard on these countries, leading to extraordinarily steep recessions. What is more, mortgages, as well as consumer credits were mostly issued in euros rather than local currencies. The interests of the foreign owners of their banks, as well as the magnitude of foreign currency loans forced these countries into 'internal devaluation' once the crisis broke out.

Hungary shares, to some degree, the worst of both worlds. As an export-oriented economy, it suffered from the breakdown of the German market in a similar way as its Central European neighbors. Moreover, while all Central European countries had tried with some success to rein in their public debt and deficit before the crisis hit, in Hungary a 'pathologic' welfare state has left public finances in disarray. To add insult to injury, Hungarian mortgage lending took almost Baltic proportions. As banks issued mortgages in Swiss francs rather than euros, and as the Swiss franc has appreciated enormously ever since the crisis broke out, Hungary's middle class now has to cope with

an alarming increase of their debt. While debtors in Latvia and Lithuania can at least still hope for their countries to join the eurozone, such a step would not help the indebted population in Hungary. All in all, it comes therefore as no surprise that the country has turned repeatedly into a hotspot of the global financial crisis, leading to political destabilization, too.

Virtuous and vicious political circles

Finally, governments in the region have shown very different capacities to cope with the consequences of the crisis in a way that would be tolerated by their populations. Interestingly, these capacities do not coincide with the economic problems countries are facing or the costs societies have to bear. Take the examples of Estonia and Latvia. Both experienced especially hard landings after their housing bubbles burst, with GDP contracting in 2009 by 15 and 19 percent, respectively. Moreover, both countries kept their currencies pegged to the euro, and opted for a very sharp domestic adjustment by implementing some of the toughest austerity packages in Europe. But only Estonia can claim to have successfully coped with the consequences of the crisis. The Estonian government could rely on an unusual degree of popular acceptance of deep wage cuts, massive public-sector layoffs and soaring unemployment. Unparalleled in Europe, there has been no single major protest event in Estonia following the austerity packages. Estonians' trust in government has stayed high throughout the crisis. Unchallenged by popular protest, and at the price of a very sharp adjustment, the Estonian government brought its public finances back on track within one single year, this way even qualifying for adopting the euro. Indeed, as one observer has identified, the source of Estonia's ability to overcome the crisis seems to lay in its population's extraordinary willingness to endure hard times (Aslund 2010).

In Latvia, in contrast, tensions and dissatisfaction with the political elite have been accumulating for a long time. Trust in government has been abysmally low, and the Latvian population had repeatedly taken to the street even before the crisis broke out to protest against corruption and unresponsive government. Protests intensified when the austerity plans were unveiled. The 'penguin revolution' of 2009 brought about the fall of a first government, a second one fell a year later, and a third in 2011. Reform priorities have been challenged not only by public discontent but also by the constitutional court and opposition parties, and within governing parties themselves. In light of this, it is striking that Latvian policymakers so far have not erred from deep austerity and internal devaluation. The country has entered a vicious circle from which there is no easy way out. Despite popular discontent, successive governments continue unpopular policies. However, as they lack the capacity to implement these policies successfully, economic problems keep accumulating.

Latvia is not the only country in which deep political tensions have impaired the capacity of governments to simultaneously meet the requirements of crisis management and popular demands for protection against social hardship. In some cases, therefore, the specter of a democratic breakdown, so often invoked at the beginning of the transformation, is coming to the fore again. Ironically, it is Hungary, the former poster-child of transitology, which has traveled furthest down this road.

Conclusion

Much of this suggests that East-Central Europe has indeed ceased to exist as a region that shares a similar past, as well as similar problems and prospects. While some countries have been sailing quite smoothly through the crisis, other countries are living through a protracted crisis, some of them getting dangerously close to the breakdown of market economy, and democracy alike. There are, however, two reasons to believe that this does not spell the end of East-Central Europe. First, a major trademark of the region is that market economy

and democracy have remained very fragile ever since socialism broke down. Second, this text is being written at a time when the crisis of the eurozone has taken East-Central Europe away from the spotlight of markets and observers. The point in time might not be far, however, when the region's multiple dependencies on West European markets, banks and investors will turn all of it once again into a hotspot of the crisis.

References

Aslund, Anders. 2010. *The Last Shall Be the First: The East European Financial Crisis.* Washington, DC: Peterson Institute for International Economics.

Becker, Torbjörn, et al. 2010. "Wither Growth in Central and Eastern Europe? Policy Lessons for an Integrated Europe." Bruegel Blueprint Series No. 11.

Becker, Joachim, and Johannes Jäger. 2010. "Development Trajectories in the Crisis in Europe." *Debatte: Journal of Contemporary Central and Eastern Europe* 18(1): 5–27.

Bohle, Dorothee. 2011. "East European Transformations and the Paradoxes of Transnationalization." In *Transnational Europe: Promise, Paradox, Limits,* ed. Joan DeBardeleben and Achim Hurrelmann. New York: Palgrave MacMillan.

Bohle, Dorothee, and Béla Greskovits. *Capitalist Diversity on Europe's Periphery*. Ithaca, NY: Cornell University Press. Forthcoming.

Dale, Gareth, ed. 2011. *First the Transition, then the Crash: Eastern Europe in the 2000s*. London: Pluto Press.

Hölscher, Jens. 2009. "Twenty Years of Economic Transition: Successess and Failures." *The Journal of Comparative Economic Studies* 5: 3–17.

Marer, Paul. 2010. "The Global Economic Crises: Impacts on Eastern Europe." *Acta Oeconomica* 60(1): 3–33.

Myant, Martin, and Jan Drahokoupil. 2010. *Transition Economies: Political Economy in Russia, Eastern Europe, and Central Asia.* Danvers, MA: Wiley.

Pistor, Katharina. 2009. "Into the Void: Governing Finance in Central and Eastern Europe." New York: Columbia Law and Economics Working Paper No. 355.