**EAST AND CENTRAL EUROPE:**

**The Impact of 2008-09 Global Financial Crisis[[1]](#footnote-1)**

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My remarks this morning will be focused on the question whether the European Union (EU) membership has helped or hindered the East and Central European (ECE) countries in coping with the recent global financial crisis. Before I delve into this question, let me suggest that the economic structure and institutions that the ECE countries had inherited from the Soviet dominated political relationship in the 1990s were quite different from the well established economics of the Western European Countries (WECs). The decade of 1990s was spent by the ECE countries in privatizing state-owned enterprises and banks, establishing autonomous central banks and regulatory structures and laying foundations for institutions that support markets. Therefore their response capacity to the crisis must be judged against this fundamental structural difference between the ECE and WEC blocks.

The main point I would like to make is that it were some of the Western European Countries – PIGS (Portugal, Ireland, Greece and Spain) that have undergone most of the difficulties during and in the post crisis periods. A few of the ECE countries had suffered as a result of the crisis initially but none had the same intensity or duration as PIGS. Therefore, the membership of EU per se is not a relevant differentiator between various groups of EU countries. I would argue that international assistance and domestic policy responses were more critical than the membership of EU.

It is true that the ECE countries have actively pursued real and financial integration with the WECs over the past two decades. Several of them recorded very rapid growth during the 2000s and therefore became quite strong in the period before the crisis. Timely global assistance came to the rescue of countries such as Baltics, Hungary, Romania and helped avert the economic meltdown. Sovereign debt / GDP ratios of ECE countries were generally lower going into the crisis compared to those of the WECs. But the foreign banks – mainly Western European – found the ECE markets quite attractive and had injected abundant credit in the mid 2000s. While bank credit did stimulate growth increased consumption and associated bubble in the real estate market intensified current account deficit in many countries.

In the immediate aftermath of the crisis in September 2008, debts denominated in Euro or Swiss Franc became harder to service as local currencies weakened. There was a widespread fear that foreign banks would withdraw funding to finance domestic credit in their home countries. Domestic branches of foreign banks had taken loans in foreign currency from their parent banks more so in Baltics and South Eastern Europe.

As a result of this swift and coordinated global action (the G-20 London Summit in April 2009 ensured that the IMF had sufficient resources to offer) and the Vienna Initiative which further ensured that foreign banks did not pull out of the region there were few bank collapses, no systemic banking crises, and no sovereign defaults in the ECE countries. Few Governments were toppled and populist or extremist parties did not make much political gain. IMF led programs provided financial assistance of € 52 billion to Hungary, Romania, Latvia and Ukraine. This avoided the regional meltdown although Baltics and Ukraine did experience economic declines rarely seen in peacetime.

Central Europe (CE) also benefitted from Germany’s stimulus package. Economic downturn accelerated a shift of businesses from Western Europe to low cost Central Europe. Multinational Corporations generally pressed on with on-going investment projects and foreign investments inflows for financing current account deficits did not slow down. Countries themselves took timely austerity measures to cut down on fiscal and current account deficits.

Although the ECE countries have fared well the road ahead remains rocky and they remain vulnerable to any further slowdown in the Eurozone – the region’s main export market. Domestic financial sectors are largely bank based and outside Czech Republic, Hungary and Poland, Bond and Equity markets are not well developed. Corporate bond markets are very small and illiquid. So are equity markets. Non bank financial institutions such as Pension Funds, Insurance Companies, etc. are just beginning to develop. Institutional infrastructure for the financial sector is deficient in many countries and the local subsidiaries of foreign banks are not well capitalized. Domestic loans are generally denominated in foreign currency and are extended to unhedged domestic borrowers. Asian crisis of the mid 1990s was triggered largely by this mismatch in currency and maturity between the lending banks and the borrowers – the Corporates. The banks therefore are exposed to credit risk while the domestic firms are exposed both to exchange rate risk as well as interest rate risk.

The potential for financial spill over across sovereigns remains elevated. Renewed financial sector stress could spread to ECE countries via trade and cross-border bank flows and could have significant adverse effects on real activity (IMF 2010). According to the IMF the countries that had experienced unsustainable domestic booms (Bulgaria, Latvia) or have vulnerable private or public sector balance sheets (Hungary, Romania) are expected to recover more slowly. These problems have tightly constrained the room for policy maneuver.

Multispeed recovery is likely to take place in ECE countries. Catching up with Western Europe will be longer, more complex. Some countries will converge faster than others. Poland was the only EU state that avoided recession and is on a steady growth path. On the other hand former Yugoslav states could lag behind other countries putting at risk fragile political stability. Czech Republic, Slovakia and Slovenia will also power ahead. These countries are low cost manufacturing centers and would integrate well into the supply chain of Germany. They export into Germany what Germany then exports into other countries.

1. Keynote address at International Seminar on East and Central Europe organized by the Area Study Centre for Europe, University of Karachi on November 24-25, 2010. [↑](#footnote-ref-1)