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Reforms offer crash lifeline

By Kunal Kumar Kundu

The recent journey of the Central and Eastern European (CEE) economies is essentially a story of transition from communism to capitalism, with a majority of the economies being curved out from the erstwhile Soviet Union.

While the transition was difficult, most of these countries embarked on the path of economic reforms as they wanted to be a part of the European Union. As the union enlarged, most of them entered the EU by 2007.

These economies then became an important source of growth of the developed Western European economies by providing cheap labor and attracting huge inflows of capital from developed Europe, as the costs of production were much lower in the eastern part.

The eastern enlargement of the EU, in 2004 and 2007, should be understood within this context.

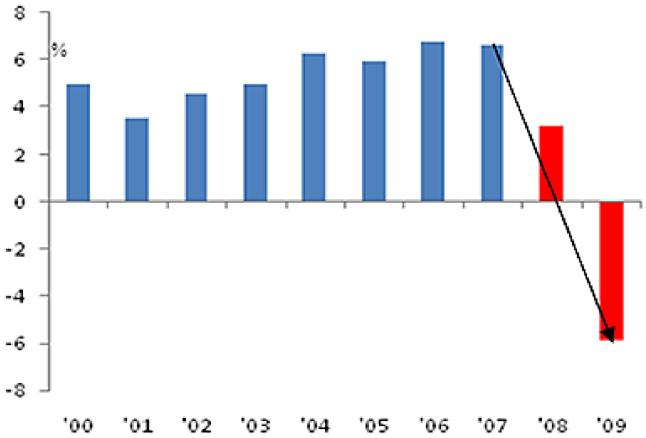
Not surprisingly, the CEE countries enjoyed high economic growth as they entered the EU. Between 2004 and 2007, economic growth averaged about 6.4% in these economies and the average rate of unemployment declined to a little more than 6% in 2007 from around 10% in 2003. These growth rates were fueled by a huge inflow of private capital. This was particularly high in the economies in the Baltic states (Lithuania, Latvia, Estonia), where growth rates soared into double digits.

Unemployment was eased by the ability of workers to move to Western Europe (despite restrictions maintained by some countries such as France and Germany). This was most evident in Poland, the largest of the CEE countries, where around 1.5 million workers moved to Western Europe, helping to reduce the country's unemployment rate to 10% in 2007 from nearly 20% in 2004. Consumers in CEE benefited from an inflow of products from Western Europe and the greater availability of cheap credits.

Another important feature of the growth achieved during this time was the availability of some funds and subsidies from the EU. These funds differed from private capital in that these were directed towards investing in infrastructure and fostering the development of the EU's poorest regions.

Despite the impressive economic growth enjoyed by the CEE economies following the EU accession, the growth could be attributed mostly to structural rather than fundamental factors. Most of these economies became increasingly reliant on an inflow of capital from the West. Private business and consumption were buoyed by a dramatic rise in foreign borrowing, while an increase in imports expanded the region's already large trade deficit with Western Europe. It is not a surprise, therefore, that these economies would experience devastation as the global financial crisis unraveled itself.

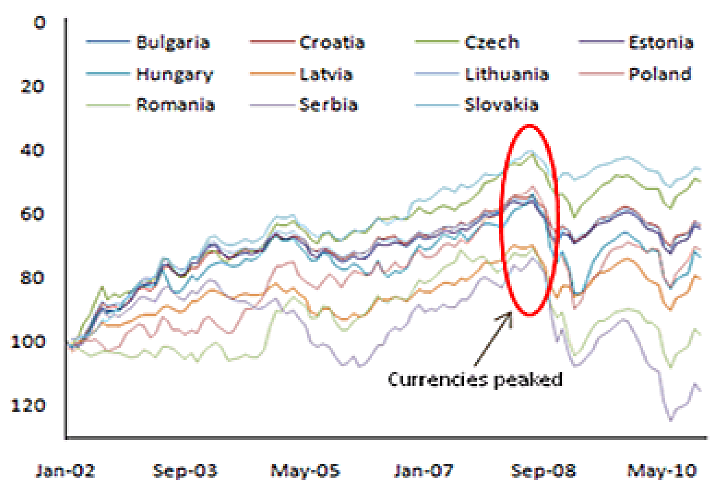
Average growth of CEE economies



Source: IMF WEO, our calculation

This exposed the fragile nature of the growth. As mentioned above, over the past many years, both foreign and domestic banks in these countries went into overdrive to offer cheap loans and mortgages to consumers. A lot of this credit was lent in foreign currency - primarily euros and Swiss francs - which offered interest rates that were substantially lower than that of their local currency equivalents.

This led to a virtuous cycle of a growing economy, leading to a stronger currency (the chart below shows movement of domestic currency vis-a-vis US$) and higher inflows.



Source: Various central banks

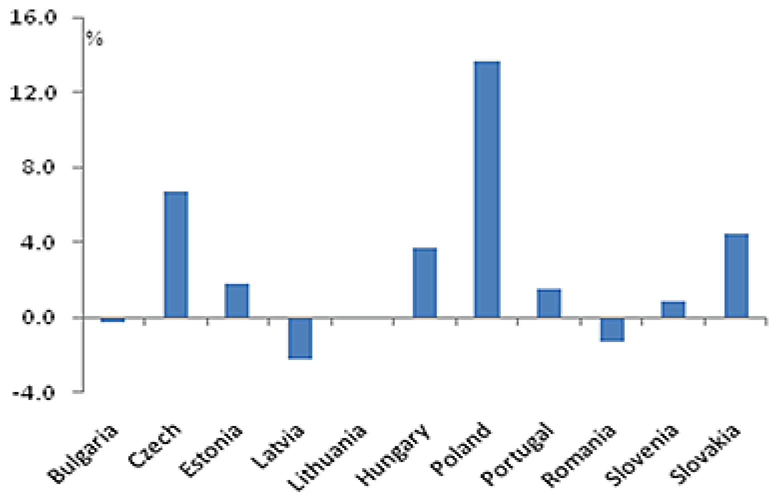
As the economies crashed (nay contracted), a sense of deja vu prevailed, with the fate of the CEE economies appearing like those of the crisis-hit East Asian economies in 1997 - high current account deficits, indiscriminate lending by banks, high capital inflows, over-valued currencies and so forth.

The implosion of global financial markets also exposed the vulnerability of the region's banking sector, while a shortage of foreign capital (as the risk perception of these economies increased manifold) threatened their ability to finance their current account deficits. Housing bubbles burst in some CEE countries, while currency devaluations severely impacted regional households that had accumulated foreign exchange-dominated mortgages in the pre-crisis years.

By 2009, save for Poland, CEE economies had set into contractionary mode with Latvia, Lithuania and

Romania being most hit (shrinking between 14% and 18%), followed by big dips in Slovenia, Romania and Hungary.

These economies are, however, showing modest signs of recovery now.



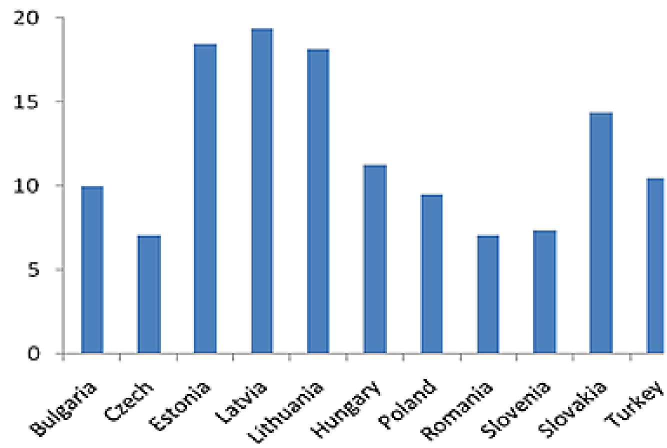
Source: Eurostat

However, if one takes away Poland and Czech Republic, the average growth rate (and hence recovery) during the first nine months of 2010 is quite "feeble and uneven", to borrow a phrase from World Bank.

While many an economist feels confident that the CEE economies will recover soon, we are not as confident about the region as a whole, because of the following:

- Trade in CEE countries remain largely tied to demand conditions within Europe, with exports to euro area accounting for 50% of total exports on an average and intra-regional exports comprising another one-third of total. The Baltic region is marred by even a higher degree of inter-dependence for exports. With uncertainty prevailing around euro zone recovery, CEE exports are unlikely to rebound to pre-crisis levels

- Stubbornly high unemployment rates, subdued private sector credit growth, and investments being held back due to excess capacity should mean that domestic demand will fail to provide necessary impetus to the growth momentum. Domestic demand continues to fall in Croatia, Estonia, and Hungary, and following only a mild recovery in the last few quarters, remains about 20-30% below pre-crisis levels in the Baltics and Bulgaria



Source: Eurostat
Note: Data as of June '10

- The financial crisis caused Eastern European countries' fiscal deficits to swell, making it extremely difficult to achieve the Maastricht Treaty (on EU membership) criteria of a maximum deficit of 3% of GDP per year and a total public debt ceiling set at 60% of GDP. This prompted many countries to adopt temporary measures to control the deficit, which may lead to further worsening of the fiscal balance in the medium/long-term. Romania, Latvia and Serbia continue to be under International Monetary Fund supervision. Both Lithuania and Estonia started reducing the amount of pension pre-funding on a temporary basis, due to immediate liquidity needs

More importantly, similar to Europe, CEE faces the problem of population aging. Similar to Europe, the population of CEE countries is aging faster (in fact at a rate much faster than the rest of emerging economies), with the dependency ratio rising sharply after 2040. This will have an adverse impact on the countries' fiscal balances (with increasing pension claims) and lead to lower output growth.

Having said this, it is important to note that not all countries have the same growth trajectories and the region's economies are characterized by multi-speed growth.

Poland, the region's largest economy, for example, stands out as the most robust one. The country that embraced the so called "shock therapy" (embarking on an economic reform process that entailed wide spread privatization, tax reforms and so on) in 1990 to ensure rapid transition from communism to capitalism has been able to bear short term pains and to develop a structurally sound economic model.

It has a large domestic market (which reduces its dependency on exports and hence less exposure to global vulnerabilities), is blessed with diversified economic activities (flourishing industries like agro-processing, construction, energy, food and beverages, machinery, medical devices, motor vehicles, pharmaceuticals) and has ensured development of several economic clusters outside of their capital Warsaw (such as in Bydgoszcz, Gdansk, Katowice, Krakow, Lodz, and Wroclaw). Not surprisingly, Poland was the only European economy that continued to grow in 2009.

All of these have helped bolster Poland's capacity to attract foreign direct investment, an important determinant of sustainable growth as the short-term effects of the stimulus program wanes off. In fact, Poland is the only country in this region to be in the top 10 in AT Kearney FDI Confidence Index 2010, as it moved up to be the sixth-most attractive destination, with the only European country to be ahead of it being Germany (fifth).

Unlike Poland, the other countries have been much too slow in bringing about relevant structural changes in their economies as they transitioned from the communist regime. While some of the economies can weather the storm, albeit slowly, recovery remains uncertain in some. The most vulnerable economies of the region are Bulgaria and the three Baltic countries.

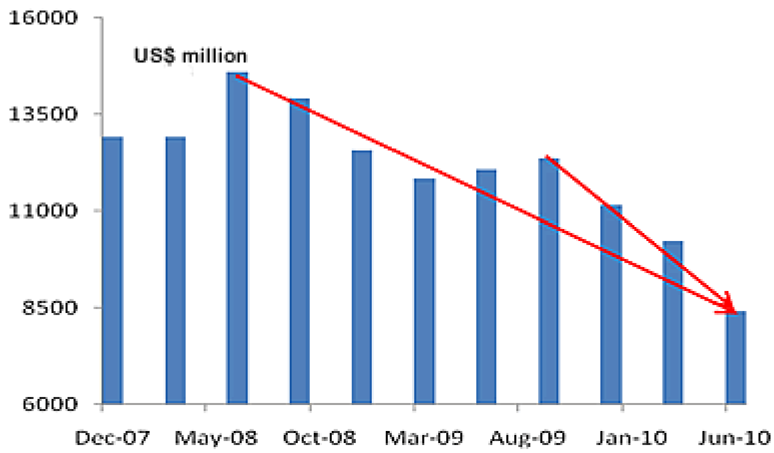
Bulgaria has one of the highest current account deficits (CAD) among the CEE countries. Between 2006 and 2008, the average CAD was a little more than 23%. With the onset of the global financial crisis, a sharp reduction in capital flows pulled down imports and by 2009 the CAD was down to nearly 10%. However, the reduction in imports reduces the growth potential of the economy that has one of EU's lowest per capita incomes and is hugely dependent on imports to bridge the developmental gap.

The three Baltic countries have experienced dramatic slowdown recently. Earlier, these were one of the fastest growing economies in Europe and between 2000 and 2007; they grew on an average of 7.5 to 8.8%. However, the combination of large and unsustainable current account deficits (averaging between 8 to 12% for the Baltic countries between 2000 and 2007), excessive credit growth, and mounting housing bubbles resulted in crash landing of the economies.

By 2008, while Lithuania managed to grow (2.76%), Estonia (-5.06%) and Latvia (-4.24%) shrunk. Next year, these economies shrank the most (about 14% for Estonia, 18% for Latvia and 15% for Lithuania).

Not only have these economies experienced a sharp reduction in FDI flows, credit from the Western European banks have also tapered off substantially, further impacting their growth prospects. Clearly, these countries' over-dependence on foreign capital domestic growth stimulus puts them at a greater risk.

Exposure of Western European banks to Baltic countries



Source: BIS

Apart from these economies, the 2011 outlook remains weak for the other large economies of the region, ie Croatia, Romania and Hungary, which together accounting for about 35% of the region's GDP. Romania and Hungary have been the worst-performing economies in CEE (excluding the Baltic countries) during the past two years, with both economies going into crisis with large twin deficits and a huge stock of foreign currency-denominated household credit.

Due to its high integration in global trade and financial markets, elevated pre-crisis vulnerabilities, and weak structural foundations for growth, Hungary was more immediately and profoundly affected by the recession than other countries in the region.

The combination of improved policies and significant adjustment in the context of the IMF/EU-supported program, availability of large and upfront official financing, and an easing of global financial conditions, brought a faster-than-expected stabilization. After a deep initial slump, an export-led recovery is underway, but domestic demand remains sluggish as the private sector continues to adjust balance sheets. Growth in Hungary is expected to remain fragile, and a rating downgrade may not be surprising.

Romania's economic recovery remains the weakest in the region with growth held down by fiscal austerity measures and higher food prices, together with weak domestic demand and declining net exports. With further fiscal austerity measures introduced in July last year to keep IMF/EU mandated fiscal targets on track, Romania is likely to take several years to make up for lost output.

Croatia, another large economy of the region, slipped into recession as the credit-led growth busted. The country contracted 5.8% in 2009 with reduced capital inflows and external demand. With external debt at 102% of GDP and CAD at 6% of GDP at end 2009, and significant balance sheet exposures to interest and exchange rate induced risks, market confidence in Croatia deteriorated sharply on the heels of the crisis. Although timely policy response helped improve the financial market sentiment, the economy is poised for a period of slow growth and rising debt due to low competitiveness and large fiscal deficit.

To conclude, the high growth economies that the CEE countries were (which included the erstwhile Baltic tigers) had to endure a crash landing as the global financial crisis erupted. While there is some semblance of recovery now, it is quite feeble and uneven.

While Poland has emerged as the strongest economy in the region (having successfully reformed its economy), Bulgaria and the three Baltic countries remain the most vulnerable in the region. Croatia, Hungary and Romania, though not as vulnerable, are also on a weak wicket and would endure prolonged period of low and slow growth.

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