



## RGE Monitor's Newsletter

### **Roubini Global Economics: Eastern European Tinderbox – How Explosive Could It Get?**

By [RGE Monitor](#)

The Central and Eastern Europe (CEE) region is the sick man of emerging markets. While the global crisis means few, if any, bright spots worldwide, the situation in the [CEE area](#) is particularly bleak. After almost a decade of outpacing worldwide growth, the region looks set to contract in 2009, with almost every country either in or on the verge of recession.

The once high-flying Baltics (Estonia, Latvia, Lithuania) look headed for double-digit contractions, while countries relatively less affected by the crisis (i.e. Czech Republic, Slovakia and Slovenia) will have a hard time posting even positive growth. Meanwhile, Hungary and Latvia's economies already deteriorated to the point where IMF help was needed late last year.

The CEE's ill health is primarily driven by two factors – collapsing exports and the drying-up of capital inflows. Exports were key to the region's economic success, accounting for a significant 80-90% of GDP in the Czech Republic, Hungary and Slovakia. By far the biggest market for CEE goods is the Eurozone, which is now in recession.

Meanwhile, the global credit crunch has dried up capital inflows to the region. An easy flow of credit fueled Eastern Europe's boom in recent years, but the good times are gone. According to the Institute of International Finance, net private capital flows to Emerging Europe are projected to fall from an estimated \$254 billion in 2008 to \$30 billion in 2009. Whether or not this is formally considered a 'sudden stop' of capital, it will necessitate a very painful adjustment process.

#### ***Classic emerging markets crisis in the works?***

What is especially worrisome is that the days of easy credit flows were accompanied by rising external imbalances that rival or even exceed the build-up of imbalances in pre-crisis Asia – e.g. current account deficits in Southeast Asia from 1995-97 fell within the 3.0-8.5% of GDP range, while those in CEE were in the double-digits in Romania, Bulgaria and the Baltics in 2008. As examined in a recent RGE analysis piece, the vulnerabilities in many CEE countries – high foreign currency borrowing, hefty levels of external debt and massive current-account deficits – suggest the classic makings of a capital account crisis a la Asia in the late 1990s.

#### ***Spillover effects to rest of world***

Like the Asia crisis of 1997-98, a regional crisis in Eastern Europe would have far-reaching effects. As Harvard professor Kenneth Rogoff noted in a recent New York

Times article: "There's a domino effect. International credit markets are linked, and so a snowballing credit crisis in Eastern Europe and the Baltic countries could cause New York municipal bonds to fall." Western Europe looks set to be particularly impacted via its strong trade and financial linkages. Of particular concern is the strong presence of Western European banks (via subsidiaries) in the CEE, where they hold 60-90% market share depending on the country, which paves the way for contagion.

[So is this the making of a cross-border banking crisis?](#) It could be. Given the sharp contraction in Eastern Europe's economies, combined with high foreign currency-denominated lending (particularly in Croatia, Hungary and Romania), weakening currencies and heavy reliance on non-deposit external financing, Eastern Europe's banks will likely see a large spike in non-performing loans. Banking systems in the region are likely only as strong as their weakest link – or in this case, weakest country. That's because of the "common lender" phenomenon. As many CEE countries share foreign parent bank(s) in common, this paves the way for problems in just one of these countries to have ripple effects into other CEE countries. So even a relatively healthy economy/banking system like the Czech Republic's – with a reasonable loan-to-deposit ratio and scant fx-denominated lending to households – is still vulnerable.

Austria is far and away the Western European country most heavily exposed to the CEE region (via Austrian-based banks like Raiffeisen and Erste Bank). These banks' collective exposure to the region amounts to over 70% of Austria's GDP. Notably, however, other Western European countries' total exposure is far less.

Belgium and Sweden are the next in line after Austria; their lenders' total exposure to the region amounts to a still significant 20-25% of GDP. Some fear that parent banks, if they get into trouble, could either fire-sell subsidiaries or simply walk away. Another concern is Europe's fragmented regulatory system, which means that if a cross-border bank needs to be unwound, the process is likely to be extremely messy.

### ***Policymakers in virtual straitjackets***

CEE policymakers have fairly limited tools to cope with the crisis. Fiscal policy is constrained by the fact that belt-tightening is required to restore order to the balance of payments in some countries (i.e. Hungary, Romania, Ukraine, and the Baltics), while euro adoption ambitions limit the fiscal response in others (i.e. Poland).

Meanwhile, monetary policy easing is constrained in countries with heavy foreign currency-denominated lending, like Hungary and Romania, where a weakening of the local currency could potentially trigger defaults, thereby impacting financial stability. In others (i.e. Bulgaria, Estonia, Latvia and Lithuania), monetary policy is not an available tool due to fixed exchange rates.

Due to limited fiscal and monetary policy options, other CEE countries might need to follow in the footsteps of Latvia and Hungary and call on IMF help. In a nod to the difficult situation of many CEE countries, EU leaders called last week for IMF resources to be doubled to \$500 billion to help head off new problems in crisis-hit countries. It remains to be seen, however, whether IMF help will be enough to return financial stability to the region.

In a recent research report, economists from Danske Bank point to the increasing concern of spill-back from problems in Eastern Europe to the Eurozone. Polish

authorities and commentators, such as Wolfgang Munchau, recently made the point that East European countries should be given a shortcut to join the euro and access to its safety and stability net.

However, current problems faced by some EMU members show that EMU membership alone is no panacea. Moreover, previous experience shows that currency pegs can be double-edged swords that often end in capitulation. The current test case for the entire region is Latvia, whose currency peg looks increasingly fragile even after its IMF-led EUR 7.5 billion bailout package. Devaluation with its ripple effects through the region would be devastating for the mostly foreign-owned banks in the region.

Unlike EMU member countries, EU countries that have not yet adopted the euro have access to the 'medium-term financial assistance' facility worth EUR 25 billion, of which EUR 10 billion in loans have already been extended to Latvia and Hungary. Additional assistance to the region will have to come from a revamped IMF, as noted before and the EBRD is also providing funds to banks in the region. Despite a 20% funding boost, however, its resources are much smaller.

### ***Spotlight on Ukraine***

European banks are also exposed to vulnerable economies outside of the EU. Russia is the second largest borrower from EU banks and it has over \$100 billion of debt that must be financed this year. However, it is the Ukraine that may pose the biggest contagion risk, particularly if the next tranche of IMF funding continues to be deferred. Austrian, French, Swedish, Italian and German banks have a collective exposure of around EUR 30 billion to the Ukraine. Ukraine has \$46 billion in foreign debt obligations falling due in 2009 and the swift plunge of the Hryvnia has boosted the cost of servicing these debts even as corporate debts are on the rise.

Ukraine's political divisions and economic contraction of at least 6% suggest further sovereign and corporate ratings downgrades are on the way. Ukraine may thus be forced to make the budget cuts required by the IMF, but it is also reaching out to the U.S., Russia, China, Japan and the EU for additional funds.

### ***Government collapse in Latvia: more yet to come?***

The series of riots that erupted in Bulgaria, Lithuania and Latvia in January, followed by Latvia's government collapse last week, raise concerns that Eastern European countries may experience a period of deep destabilization and social strife as the economic crisis deepens and unemployment rates soar. The recent wave of popular unrest was not isolated to Eastern Europe. Ireland, Iceland, France, the UK and Greece also experienced street protests, but many Eastern European governments seem more vulnerable as they have limited policy options to address the crisis and little or no room for fiscal stimulus due to budgetary or financing constraints.

Deeply unpopular austerity measures including slashed public wages, tax hikes and curbs on social spending will keep fanning public discontent in the Baltic states, Hungary and Romania. Dissatisfaction linked to the economic woes will be amplified in the countries where governments have been weakened by high-profile corruption and fraud scandals (Latvia, Lithuania, Hungary, Romania and Bulgaria). The political forces most likely to benefit from public disaffection are those running on the populist platforms, which could disrupt efforts to battle the effects of the economic crisis. Latvia could be a case in point, as there are growing concerns that the coming election

campaign might suspend the fiscal austerity measures required by the IMF bail-out package. Two other political hotspots that are at risk of early elections are Romania and Estonia, while Bulgarian national elections are due in mid-2009.

### ***EU's free market rules under pressure: Eastern disillusionment and Western protectionism***

Overall, a big rise in support for populist and radical parties in the region could put social, structural and environmental reforms on hold in the region and could even call into question the economic and political model Eastern European countries have followed since the 1990s. The eastern EU member states' decisions to open their markets and move toward greater integration with the EU are now being second-guessed by some. Moreover, the protectionist measures implemented in some western EU states in support of their automotive and financial sectors are threatening the EU's single market rules and could particularly hurt Eastern European economies.

Meanwhile, a backlash over immigrant labor is likely. With the 2009 unemployment rate set to rise to 8.75% in the EU27, according to the European Commission, member states are tempted to interpret the laws in a way more favorable to their nationals. This suggests that migration trends will reverse and the eastward flow of remittances will dwindle. The return of Eastern European migrant workers, in turn, may add to social discontent in their countries of origin.

### ***Growing East/West divide in the EU?***

The financial crisis has exacerbated the East/West divide within the EU illustrated by the persistent bickering between the Czech Republic, the current holder of the EU presidency and France over trade and protectionist bail out packages that hurt automotive industries in Poland, Czech Republic, Slovakia and Hungary.

So far, the EU has helped economically troubled Latvia, Poland and Hungary with swap lines and loans and called for the resources of the IMF to double in order to help the countries facing the crisis. Yet, there have been a growing number of calls for EU-led coordinated support to the Eastern European economies (recently echoed by the World Bank).

If there is a perceived lack of help, the financial crisis could deepen the divide between so called "Old Europe" and "New Europe" and bring structural changes to the political landscape in Eastern Europe, such as strengthening the nationalist, euro-skeptic voices in Central Europe (Czech Republic, Poland) and the pro-Russian parties in the Baltic states.

Source: [RGE Monitor](#), February 25, 2009.