The World Crisis and its Impact on the New Member States of the European Union

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The Situation Prior to the Crisis

The 2004 fifth wave of EU accession, the largest in terms of population and number of countries, was one of the most important events in the history of the European Union. It brought together countries which had experienced very different political, social and economic developments. Before accession to the EU, implementation of domestic structural reforms, which improved the functioning of markets, had already put the new member states on the path of nominal and real convergence towards EU averages. As expected, enlargement and adoption of the *acquis* brought faster economic growth, thereby helping to narrow the gap in living standards with those of the old member states. Underscoring the importance of having in place appropriate macroeconomic policies and implementing structural reforms, real convergence evolved at different speeds across countries. In general, improved economic performance was helped by the adoption of sounder fiscal, monetary and structural frameworks. Furthermore, economic restructuring and modernization in new member states was supported by increased local and foreign investment, attracted by EU product market rules and enhanced competitiveness. Foreign direct investment boosted the expansion of knowledge-intensive and service-based sectors, playing an important role in reducing the very high levels of unemployment, that had been prevalent in these countries, and in expanding significantly trade opportunities.

While substantial foreign direct investment and trade openness were key drivers of faster economic growth, they also allowed total investment to substantially surpass domestic savings, current account deficits to widen significantly, real exchange rates to appreciate in some countries and real interest rates to remain relatively low over extended periods. Current account deficits in Latvia, Estonia and Bulgaria were in double digits and in Romania and Lithuania close to 10%. The corresponding capital inflows and rapid credit

expansion contributed to the build up of inflationary pressures, strong wage demands and real estate bubbles. With about 70% of the banks in Central and Eastern Europe owned by Western European Banks (in some cases such as the Czech Republic, Slovakia, Estonia and Lithuania close to 100%), financial integration and borrowing in foreign currencies has also been substantial. In sum, the higher degree of economic and financial integration in the new member states had resulted in substantial economic benefits, but it also created important vulnerabilities linked to increased exposure in foreign exchange and rising external indebtedness. Businesses and households in many new member states (outside the euro area) became highly vulnerable to currency depreciation. As excessive fiscal deficits were also recorded in some countries (notably in Hungary and Poland) these countries faced higher costs of financing their debt. Thus, while the benefits in employment, trade, investment, rising living standards and enhanced political stability were broadly uniform, widespread complacency about extremely large current account deficits, inaction in the face of property booms and, in some cases, lax fiscal policies meant that EU membership achievements were not equally sustainable everywhere.

The Economic and Financial Crisis

Arguably the starting point and the most significant underlying factor behind the recent severe world financial and economic crisis were the persistent global current account imbalances. In 2006, the historically large US current account deficit was nearing $900 billion, with its counterpart being found in surpluses mainly in Asia and in oil–exporting countries. Global financial integration made possible larger and more persistent current account imbalances for more countries than in the past. Specifically, surpluses were invested mainly in the United States, thereby funding most of the US current account deficit, creating massive liquidity and sustaining low interest rates. At the same time, financial innovation amplified and accelerated the consequences of excess liquidity and rapid credit expansion. As inflation remained low, central banks, especially the Federal Reserve System in the US,

felt no need to tighten monetary policy but excess liquidity showed up in rapidly rising asset prices.

Aided by very low interest rates, inadequately regulated and supervised mortgage lending, and strong political pressure to promote low income home ownership, helped create widespread housing bubbles (unsustainable increases in housing prices) in the US and in several EU member states. As China and other surplus countries pegged their currencies to the dollar, there was no mechanism to correct global imbalances. With surpluses invested in low risk US government securities depressing their yields, investors turned to riskier assets in search of higher yields. These were offered in the form of complex instruments, often under-pricing risk and generating a dramatic expansion in leveraging in the financial system as a whole. High leveraging ratios (approximating 50) made financial institutions vulnerable to an even modest fall in asset values. Both financial institutions, and those who regulated and supervised them, overestimated their ability to manage risk and underestimated the capital they should hold.

When monetary policy started to tighten in mid-2006 in response to inflationary pressures, interest rates started to rise, the housing bubble began to burst leading to bank losses on mortgages and triggering a widespread disruption of credit markets. The impact of these losses quickly spread to financial institutions in Europe and other parts of the world leading to asset sales and further lowering of asset prices. Loss of confidence, triggered by uncertainty about the ultimate location and size of credit losses, led to a near total freezing of the inter-bank credit market. To maintain required capital levels, banks sold more assets and begun reducing their loan volume. The US government's decision not to save Lehman Brothers, especially its bond holders, resulted in a breakdown of confidence that shut down inter- bank money markets. In the fall of 2008, the commercial paper market also froze and the effects on the real economy soon became much more pronounced.

There were of course many other contributing factors to the world crisis, including corporate governance failures and the proliferation of derivative investments. But the key lesson, which applies to the global economy as well as to the countries of Central and Eastern Europe, is that large, lingering and unsustainable imbalances can either be corrected with policy actions (in which case adjustment will be gradual and orderly) or a correction will be forced on the economies of the world by a sudden change in the sentiments of financial markets, in which case adjustment is much more likely to be disruptive. The world economic situation leading up to the current crisis was unsustainable and required significant policy adjustments on the part of many governments. The same was true for many of the economies of the new member states.

The Effect of the Crisis on Central and East European Countries

Initially, the financial crisis affected the advanced economies of Western Europe but had little effect on the emerging economies of Central and Eastern Europe. Until September 2008, these countries did not experience any major turbulence, partly because banks in the new member states had negligible exposure to toxic assets and financial innovation was very modest. This rather slow spread of the crisis was surprising because, as noted earlier, many countries in the region exhibited significant macroeconomic imbalances. Amongst the new member states, only Latvia suffered financial strain as early as 2007. But the situation changed dramatically in mid-September 2008, when in most new member states currencies depreciated sharply, foreign currency financing became scarce, domestic inter-bank monetary markets collapsed, stock markets declined sharply and spreads on government debt widened significantly. The situation worsened so quickly and significantly as to call for strong and immediate action. Several countries started immediate discussions with the International Monetary Fund and Hungary and Latvia and, later on, Romania entered into IMF – led agreements.

Thus, since the fourth quarter of 2008, the steady convergence and integration of the new member states of Central and Eastern Europe, characterized by more rapid growth, employment creation and trade

expansion, has been looking vulnerable. Latvia and Hungary were hardest hit and the need for adjustment in these countries was most apparent, but the stability of the entire region came under serious stress. There is no doubt that institution building and policy reform associated with EU membership as well as the ongoing integration process helped the region to cope better with the crisis. Similarly, widespread bank ownership by western banks in the region and the commitment not to let any systemically important bank in the euro area fail has helped assure the flow of liquidity to their subsidiaries in the new member states. Also, EU support to the IMF and the World Bank in agreeing to substantial financing packages to Hungary and Poland has helped send a clear message of international determination to contain the crisis. Commercial banks in these countries were also supported by the ECB to roll over their debt.

On the other side of the coin, heavy dependence for trade and foreign direct investment on the rest of the EU, which had been hit hard earlier by the recession, has meant that exports from, and capital inflows to, the new member states were seriously affected. Similarly, the flight to quality, most commonly to government securities and bank deposits in the United States and Germany because of credible policies, institutions and guarantees, has affected most new member states. But again, this effect was more pronounced (as symbolized by the higher cost of credit default swaps) in those countries with larger current account deficits, as country-specific conditions shaped market perceptions of sustainability. Finally, with growing public recapitalization of banks in western European economies, and unless the easing of bank liquidity in those economies continues, there could be a substantial reduction of liquidity support to subsidiaries in the new member states.

The Impact of the Crisis on the Outlook for Convergence

Once the crisis took hold of the entire region in 2008 and into 2009, there was a broad-based and severe downturn in all new member states. Latvia, Estonia, Lithuania and Hungary were particularly hard hit with negative growth

rates near or at double digits, while Bulgaria, Poland, the Czech Republic and Romania were also experiencing negative year to year GDP growth. Financial market conditions became even tighter with substantially increased short-term interest rate spreads. The exchange rates in all states with flexible exchange rate systems (Poland, Romania, Hungary and the Czech Republic) depreciated sharply and risk perceptions, as summarized by the 5-year credit default swaps, increased in all countries. On the positive side, external imbalances are narrowing fast because of a sharp decline in imports but even the modest remaining necessary capital inflows are at risk. Some states have large short-term external financing needs, while faced with sizeable external imbalances and a large debt stock. The EU is providing a medium-term assistance facility to help contain the risks of a balance of payments crisis, conditional on strong policy commitments to correct the underlying imbalances.

With respect to the convergence criteria, inflation in most countries is declining fast amid the serious economic downturn, although in some cases this drop is moderated by exchange rate depreciation. Fiscal positions are deteriorating rapidly everywhere with substantial deficits being forecasted through 2010. Overconfidence in non-structural increases in revenues during the boom years is now amplifying the fiscal reversal. Exchange rate floaters are experiencing high volatility while those on fixed exchange rate systems have to withstand external vulnerabilities and to look forward to protracted and severe recessions. Finally, long-term interest rate convergence has been reversed and, under any scenario, the exceptionally favorable financial market environment experienced by new member states is unlikely to return in the foreseeable future.

Cyprus and the World Crisis

Like the rest of the new member states, the performance of the Cyprus economy benefited significantly from the structural reforms leading up to EU membership. The successful introduction of the euro on January 1, 2008 added to the momentum of a fast growing economy, characterized by strong employment growth, macroeconomic stability and social progress. Meeting

the criteria for euro membership prepared the country well to deal with the impact of the world economic crisis. Membership of the eurozone has clearly protected the economy from some of the more serious consequences of the world crisis, as foreign investor confidence remained strong. While as a small open economy depending primarily on the export of services, Cyprus is experiencing a significant slowdown from the 4% average annual growth rates of recent years, its growth has remained positive, unemployment has not increased significantly and the soundness of the banking system has not been affected. Cyprus has remained a very attractive business address.

At the same time, the significant increase in capital inflows which accompanied euro membership, made possible a surge in bank lending, rapid increases in housing prices and a widening of the current account deficit to an all time high of about 18% of GDP. An orderly correction seems to be now on the way, as bank lending is returning to normal levels, housing prices have stabilized and import growth is slowing down. Meanwhile, this has drawn attention to the need for the private sector to continue to show its ability to adapt to changing economy conditions, supporting productivity growth and enhancing export competitiveness. The public sector too is aiming to ensure that Cyprus maintains the confidence of capital markets, through continued fiscal restraint, keeping public debt at the recently achieved low levels and initiating structural reforms to help strengthen the economy's competitiveness and improve its prospects to resume robust growth rates as the world economy emerges from the current crisis.

Euro-area Membership

Euro adoption remains an important medium-term anchor for policies and expectations in all new member states. Six of these countries which could have joined by now have either been rejected (Lithuania) or have chosen to wait (Poland) or have some way before they can fulfill the criteria for applying. As the experience of the four new member states which have adopted the euro demonstrates, membership of the eurozone provides a substantial advantage to small open economies in times of economic crises. On the other hand,

being in the euro-zone is neither a necessary nor a sufficient condition for avoiding being seriously impacted by economic crises and undergoing serious adjustment. For example, the Czech Republic which has maintained macro-economic stability (a modest current account deficit, slow credit expansion and a reasonable budget balance) was relatively moderately affected by the crisis, while Ireland and Spain (and to a lesser extend Portugal) had to undergo severe adjustment.

In the light of the recent financial and economic crisis, the argument for entering the euro-zone by the new member states as early as possible, which normally would have been very strong, is now not clear from the point of view of managing macroeconomic stability and ensuring sustainable growth. The crisis has shown that, for countries outside the euro zone, it is not wise to rely excessively on capital inflows. These inflows are volatile and the risk that they will decline substantially in the near future has increased considerably. Therefore for these countries, whose domestic investment is primarily financed through foreign capital, staying out of the euro-zone would risk a protracted period of low growth.

On the other hand, entering the euro-zone with serious imbalances, relatively high inflation and, therefore, excessively low real interest rates, would encourage excess investment in non-tradable, such as property and other unproductive capital, risking the property price boom and bust cycle experienced by countries which adopted the euro under similar circumstances.

Countries on a fixed-exchange rate system face a special dilemma: with prices and wages likely not flexible enough, the reduction of the current account deficit made necessary by the dry up of capital inflows would imply a serious recession. But devaluation would also have a devastating effect given the large scale of foreign currency borrowing by these countries (more than 50% of total loans in 2007 for Latvia, Estonia, Bulgaria, Lithuania, Romania and Hungary). The presence of western banks in new member states, their quest for profit together with expectations of real exchange rate appreciation as a

likely outcome of convergence, encouraged this excessive foreign currency borrowing on the part of households and corporations in new member states. For the future, policy makers in new member states should look for non-distortiancy ways to limit excessive foreign currency borrowing. Meanwhile, wherever possible, a social consensus to cut nominal wages would probably be the least painful way out of the devaluation dilemma.

Concluding Remarks

Looking forward, the most serious policy challenges, which must be met through a country-specific policy response in new member states but will also require international support, include the large short-term external financing needs, which create liquidity and roll over risks; severe pressure on banking sector stability from both the asset and the funding side; the urgent need to correct underlying imbalances and restore macro stability and balanced growth in the medium-term; the difficult task for the fiscal stance to steer a careful course between absorbing the serious downturn and preserving medium term sustainability; the limitations of monetary policy under a fixed exchange rate system and the challenge of balancing carefully the tension between internal and external objectives under flexible exchange rates; and, probably above all, the essential and universal task of implementing bold and politically demanding policy reforms to support adjustment and help relaunch new member states on a sustainable growth path.