Are the transition economies of Central and Eastern Europe – more specifically, the 10 that are already members of the European Union – down for the count?

Until very recently, their prospects seemed bright. They had mostly prospered in the decade that led up to the global meltdown, narrowing the income gap with their affluent European patrons. In light of their stability, relatively low wages and strong political and cultural ties to the West, one might have expected them to pick
up where they left off after the global recession.

Hindsight has revealed the frailty of their economic institutions, their propensity to economic mismanagement and, perhaps most ominous, the ambivalence of the European organizations that have been assigned the task of rescuing them from economic stagnation. Layer this on top of the region's chronic demographic problem – collapsing birth rates and high rates of emigration that guarantee a rapidly aging population – and one must wonder whether these long-suffering pawns of great-power politics will, in fact, get back on the growth track.

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The initial post-communist successes of the Eastern European economies were based on very real reforms that opened the door to productivity change. In the early years of the transition, most of the governments in the region introduced flat taxes that minimized market distortions, privatized hopelessly inefficient state-owned enterprises through transparent public tenders, abolished tariffs and subsidies that protected the economic dinosaurs, balanced their budgets and restored some semblance of monetary credibility. However, by 2005 the low-hanging fruit had mostly been picked.

Since then, growth has largely been achieved through credit-driven consumption and housing booms, abetted by a waning commitment to fiscal and monetary prudence. Rising inflation meant that exporters lost much of their competitive edge. Capital inflows went more and more into the apparently profitable banking sector, and less and less into productivity-enhancing projects that created jobs and stimulated exports.

Moreover, emigration of a substantial percentage of the work force in response to demand for labor in Western Europe effectively put a lid on the rate of growth that could be sustained without raising inflation. Indeed, a malign feedback loop was created by the flood of remittances from migrants in Western Europe, since the hard currency propped up overvalued currencies and supported demand for credit on the part of the recipient families.

In Poland, for example, where nearly three-quarters of a million workers left for Britain in 2004 to 2007, the government released convicts from prison to toil on the much delayed construction for the Euro 2012 soccer tournament, and even sent a delegation to India in search of workers. In Romania, more than 1.5 million people of working age – keep in mind that the entire population of the country is just 20 million – left for Italy and Spain. Similar proportions of the Baltic work force emigrated, drawn by the rapidly heating economies of Britain and Ireland.

Plentiful foreign cash and serious labor shortages produced a roller-coaster-like boom and bust. Latvia, for example, grew by 12.2 percent in 2006 and 10 percent in 2007, then contracted by 4.6 percent in 2008 and is currently expected to implode by 12 to 18 percent in 2009. The influx of capital and remittances that fueled the boom supported a current account deficit of nearly 23 percent of GDP in 2007, making the citizens of Latvia completely dependent on the willingness of outsiders to supply them with purchasing power.

Most other Eastern European economies experienced similar, if less dramatic, carnival rides. Property prices and consumer spending rocketed as households and companies took advantage of the cheap credit offered by newly emboldened banks. This credit was typically denominated in euros or Swiss francs. The expectation was that, for the 10 Eastern European countries already in the European Union – Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Romania and Bulgaria, which I’ll call the EU-10 from here forward – joining the euro zone was the next best thing to a done deal. The hope was that some countries still outside (Serbia, Croatia, Macedonia) would soon pass muster.

Prices, wages and housing costs were distorted across the region, most seriously in Romania, Bulgaria and the Baltics. At the height of the bubble, for example, luxury apartments

in the Baltic capitals were more expensive than their equivalents in Copenhagen. Only Poland and the Czech Republic largely avoided the siren song of credit-fueled consumption, maintaining a semblance of monetary prudence in the teeth of the housing boom and permitting their currencies to depreciate with the goal of keeping their exports competitive.

When banks began to fail and global investors rushed to the safety of familiar reserve currencies, the combination of huge current account deficits, private debts denominated in euros and Swiss francs, and dependence on external trade made the EU-10 especially vulnerable to the credit freeze in the West and the subsequent global recession.

The intensity of the current crisis varies considerably from country to country across the region. The factors explaining the variation include:

• the magnitude of the macroeconomic imbalances when the crisis broke out.
• the degree of international market integration through trade, capital and labor.
• the extent to which domestic credit was denominated in foreign currencies.
• the degree of control that the central bank had retained over monetary policy during the bubble years.

Four EU-10 countries – the Czech Republic, Hungary, Poland and Romania – now allow their currencies to float on foreign exchange markets, and these currencies have depreciated by between 5 and 20 percent against their trade partners’ currencies since September 2008. But even these adjustments have been unable to halt the sharp decline in exports across the region. In addition, after years of being seen as an area offering attractive pickings, the region has largely been abandoned by badly burned investors. Capital inflows declined by two-thirds between the third quarter of 2008 and the first quarter of 2009, and there are real concerns about the ability of some countries to roll over short-term external borrowing in 2010.
Reliance on cross-border financing has exposed key regional lenders to the tense balance-sheet dynamics of their parent banks, with the Swedish banks most exposed in the Baltics, Austrian and Italian ones in Central Europe, and Greek and Hungarian banks (essentially the Hungarian bank OTP) in southeastern Europe. Experience from earlier crises suggests that capital flows from banks will not recover to pre-crisis levels for many years – a factor that dims the prospects of a region in which investment is virtually all foreign-financed.

**DEMOGRAPHIC DISASTER**

The “transition” in transition countries refers, of course, to the political and economic passage of these formerly communist, centrally planned states. But there is an equally profound demographic transition in progress: very low fertility levels and ongoing emigration virtually guarantee that these economies will age more rapidly than those in other regions. By 2025, more than one Bulgarian in five will be over the age of 65 – up from just 13 percent in 1990. And while countries in other parts of the world are also aging at a phenomenal pace – notably Japan, Korea, Germany and Italy – no other region faces the challenge of building a modern, highly productive economy as the portion of the population eligible for retirement explodes.

The steep declines in fertility in the teeth of post-1990 uncertainty are frequently interpreted as a temporary reaction to the uncertainties of economic and political transition. Yet, while there was a slight blip up in the prosperous years of the post-2000 bubble, these economies seem to be past the point of demographic return: fertility would have to increase by more than one-third just to replace the existing population.

**APRÈS NOUS, LE DÉLUGE**

Since the proximate cause of the crisis was to be found in global financial turmoil, it was perhaps only natural that the financial sectors of the countries most dependent on the international flow of funds would be hit first and hit hardest. In the autumn of 2008, as financial difficulties in the advanced economies led to a decline in global liquidity and a flight from risk, investors began to differentiate among emerging markets. Hungary’s high debt levels and glaring vulnerability to liabilities denominated in foreign currency led to a stampede for the exits in mid-October.

The Hungarian case represents one extreme. For one thing, in addition to a big current account deficit, Hungary had been piling up recklessly large domestic fiscal deficits. Indeed, these deficits averaged more than 8 percent of GDP in 2002 to 2006, exhibiting a tendency to rise sharply in the run-ups to parliamentary elections. As a result, government debt reached 66 percent of GDP by the end of 2007.

For another, Hungary’s banks were exceptionally well integrated with the rest of the European banking system. So, after the central bank belatedly tightened credit in mid-2006, households and corporations still found it easy to borrow. But at a price: More than half of the outstanding bank loans to the nonfinancial sector are denominated in foreign currencies (mostly euros and Swiss francs), and over 85 percent of domestic mortgages created since 2006 have been in Swiss francs. This exposed Hungarian borrowers – and, thus, Hungarian bank lenders – to enormous exchange-rate risk.

The Latvian picture is not dissimilar. Euro-denominated mortgages amount to over 90 percent of the total, and years of unsustainable growth produced large current account deficits. The ensuing problems came to a
head in November 2008 in the form of an acute financial and balance-of-payments crisis. There was a run on the banks, with flight from Parex Bank (the second largest bank in Latvia, and the largest domestically owned one) in the vanguard. The stress on Latvia’s capital market was further complicated by the existence of a currency peg with the euro that effectively forced the central bank to bear the full brunt of the private capital flight. Official reserves fell by one-fifth in less than three months.

Hungary and Latvia were thus forced to negotiate loans from international lenders of last resort. Hungary got a total of 20 billion euros from the IMF, the EU and the World Bank. Latvia managed 7.5 billion euros from the IMF, the EU and the European Bank for Regional Development.

**SO WHO’S IN CHARGE?**

It may seem strange that the financial rescue packages for countries that are full members of the European Union should be organized from Washington – even more so when the EU itself provided most of the money. To understand why this happened, consider three points.

First, at the heart of the EU system lie two principal institutions: the non-elected European Commission run by a permanent bureaucracy and the European Central Bank, which is effectively a union of the central banks representing the 16 member states of the euro zone. With this awkward, decentralized governance, it has a very hard time reaching agreement on even modest policy initiatives.

Second, bear in mind that the core members of the EU – Britain, France and Germany – were heavily preoccupied with their own financial crises at the time of the rescue. Thus, a certain division of labor seemed desirable, if only to avoid system overload. Further, the IMF is a tested specialist in emerging market crises and, for all their status as full EU members, the EU-10 are still effectively emerging economies.

But there was a third reason. The EC has had enormous difficulty in imposing fiscal and financial discipline dictated by the pacts that set the terms for joining the common currency zone and remaining members in good standing. Thus, the IMF was seen as a firmer hand by which order and discipline could be imposed on the unruly governments on Europe’s eastern fringe.

**A HOLLOW RECOVERY?**

The path-of-least-resistance errors that led to the boom and bust in the EU-10 are now plain: forbearance on monetary policy, big budget deficits and outsize current account deficits; a lack of will to stop the private sector from borrowing massive sums denominated in foreign currency; a tolerance for wage-driven inflation, apparently motivated by the popular view that the big gap in wages between Eastern and Western Europe was inherently unfair. Don’t forget, moreover, that the very process of EU integration had made national policymakers’ jobs more difficult by
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creating unrealistic expectations on the part of investors.

If the first years of this century can now be regarded as something of a lost decade, the coming ones look even more challenging. As noted earlier, the EU-10 are aging rapidly: 20 to 25 percent of their populations will be over 65 by 2025. The region is thus going to have to shoulder ever-larger outlays for health care and public pensions with taxes on a work force that is growing slowly, or even shrinking.

These are precisely the sorts of problems – problems that require early action if there is to be a soft landing – that are difficult for all democracies to deal with constructively. But the consequences of aging will be especially acute in Eastern Europe. On the one hand, a vast majority of the elderly are eligible for public pensions, in many cases obligations inherited from the pre-transition era. On the other, unusually large numbers of people (by European benchmarks) work outside the formal employment system, and are thus not contributing to public retirement funds.

Given the political will, Eastern Europe’s demographic time bomb might still be defused. The most pressing need is for labor market and tax reforms that bring more people into the formal system. But other obvious measures to close the gap between future revenues and entitlements include:

- increasing the standard age of retirement.
- campaigning against the epidemic health problems (smoking, alcoholism, obesity) that make it impractical to demand labor force participation past the early 60s.
- improving legal opportunities for flexible, part-time work.

These unpopular measures alone, however, would be insufficient to provide the labor force needed to sustain the rapid growth. The ongoing inversion of the population pyramid has to be halted – which, as a practical matter, means importing workers from other countries. The potential is presumably there: vast numbers of workers from Asia, Africa and the Middle East (not to mention the most benighted remnants of the Soviet empire) are desperate for a living wage. But, as in Western Europe, the politics of immigration are deeply divisive. Meanwhile, the lack of convergence in living standards between Eastern and Western Europe is bound to ensure that the region will continue to lose native-born workers.

In any event, a focus on demographic fixes
puts the cart before the horse. The first requirement for a return to sustainable growth is reform that ensures price stability, encourages domestic savings, and channels capital into highly productive assets. Eastern Europe’s current dependence on multilateral lenders ought to give those lenders a fair amount of leverage in pressing for fiscal prudence, external balance and financial reform. But the current division of responsibility between the IMF and the European Commission makes the leverage difficult to exercise.

While the decision to involve multiple multilateral lenders in the EU-10 bailouts had a certain logic, the passage of time has revealed the difficulties in maintaining a united front in the face of political pressure to reduce the pain of reform. EU-10 governments are becoming more adept at playing one institution against the other. Consider, for example, the difficulties the IMF has had in imposing its patented form of tough love on the Latvian government after the European Commission expressed its willingness to deliver the next tranche of aid.

The need for external pressure for reform – as well as for vast amounts of capital – won’t go away anytime soon. Nor can reforms be sure to stick until the EU-10 are fully integrated into the European economy. Hence, the importance of a commitment on the part of Old Europe to see the effort through – a process that would require considerable political and economic flexibility on the part of the EU.

First and foremost, this will involve a relaxation of the original Maastricht Accord criteria for membership in the Economic and Monetary Union. The EU-10 complain about double standards. And not without reason: the fiscal requirements for Greece, Portugal and Italy were far less demanding than those being asked of Eastern European countries.

By the current criteria for new entrants, the government deficit must not exceed 3 percent of GDP, while the ratio of gross government debt to GDP must not exceed 60 percent. In cases where the debt-to-GDP target is simply not practical, the ratio must be approaching the reference value at a satisfactory pace at the time of application. (There is also a price-stability requirement. But in the current deflationary climate, that is not really an issue.)

One consequence of the bailout, however, is that the debt-to-GDP ratios disqualify both Latvia and Hungary. The EC estimates that Latvian government debt will reach 77 percent of GDP in 2011; the comparable figure for Hungary is 82 percent.

**EUROPE AT THE CROSSROADS**

A crisis exacerbated a lack of good economic management and political will on the part of national governments in the transition economies of Central and Eastern Europe, but it was hardly caused by these factors. The prospects for speedy convergence in living standards between Western Europe and the newest 10 members of EU were never as bright as pre-crisis conventional wisdom suggested. Now, it is all too apparent that full integration of the EU-10 would take a lot of patience – and tens of billions of euros in aid. Yet even a strong commitment to stay the course wouldn’t guarantee a happy ending.

The European Union thus faces a dilemma. A show of solidarity with the EU-10 in its time of troubles would keep the dream of a united Europe alive. But accepting the responsibility to reform the EU-10’s economies would add to the political and economic tensions that are already sorely testing the cohesiveness of the affluent members of the European Union.

How the EU will respond once the threat of financial collapse is past is unclear. What is clear, though, is that the decision will have a profound effect on Europe’s future.