The Crisis and Policy Responses in Eastern Europe

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After the Crisis: Planning a New Financial Structure

Should Greece follow Estonia? Or, does internal devaluation work?

	CDS January 1, 2010	CDS March 31, 2010	Public Spending (2008➔2009)	Government debt, 2009Q03 (% GDP)
Greece (euro)	283.4	335.9	Ca +9%	113.2%
Estonia (euro-peg)	186.3	91.4	Ca -12%	6.2%
	Source: CMA	Source: CMA	National Statistics	Source: Eurostat

Official Europe and markets certainly seem to think so. However, this is based on miscued understanding of what has happened in Eastern Europe, particularly in the Baltics

Growth Strategy and Policies

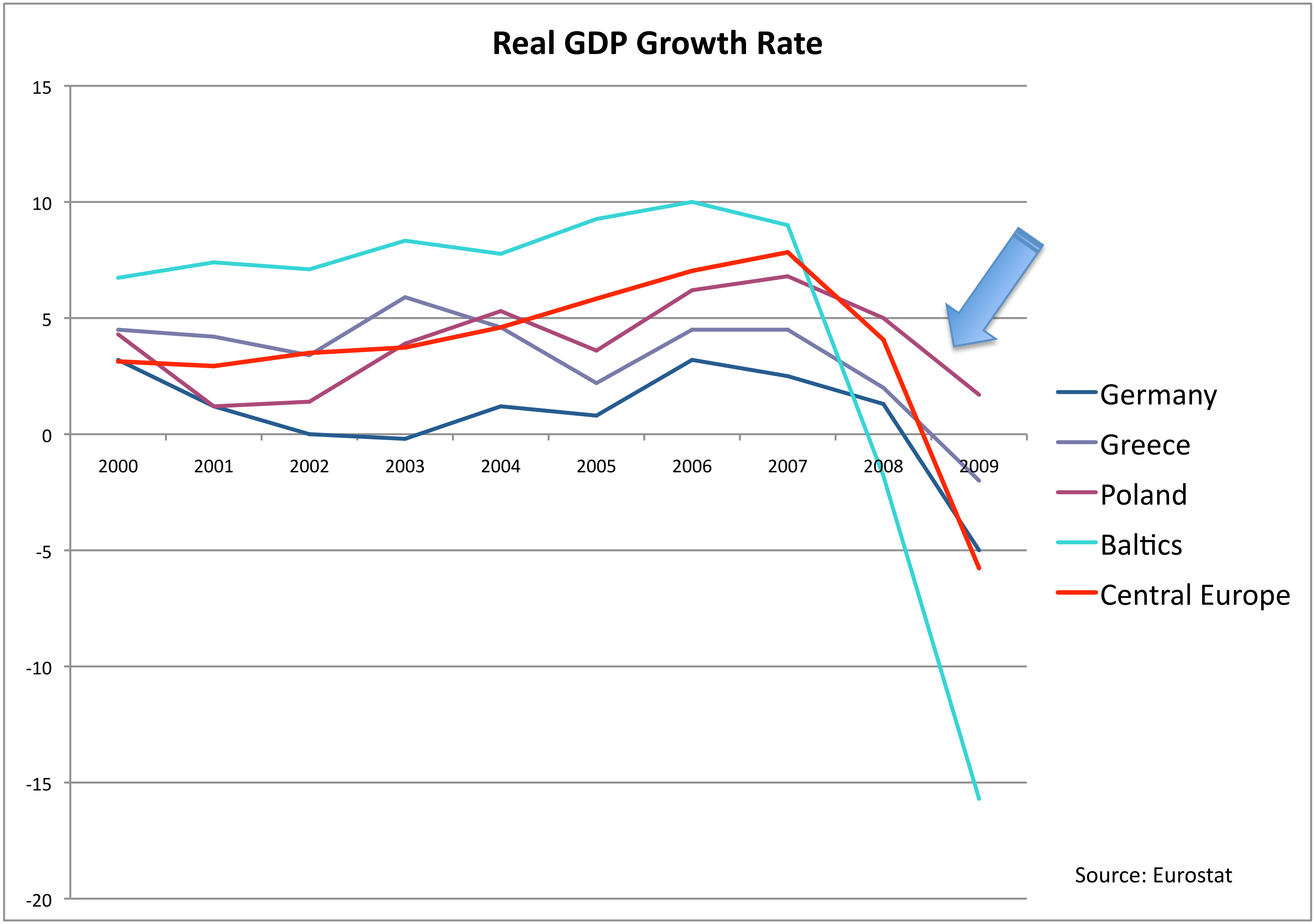
- Killing the Geese (de-)industrialization
- Foreign savings led growth strategy during the last 2 decades
  - FDI (1/3 of emerging market FDI in 2000s), key destination finance and real estate (up to 2/3 at peak)
  - Massive cross-border lending by newly foreign owned (up to 97%) financial sector, much of it in foreign currency (up to 80%), much of into real estate
  - Exports (up to 80% of GDP) through European production outsourcing
- Aided by generally neoliberal macro-economic policies (and by currency pegs in the Baltics)
- Highly pro-cyclical environment

Such growth strategy brought …

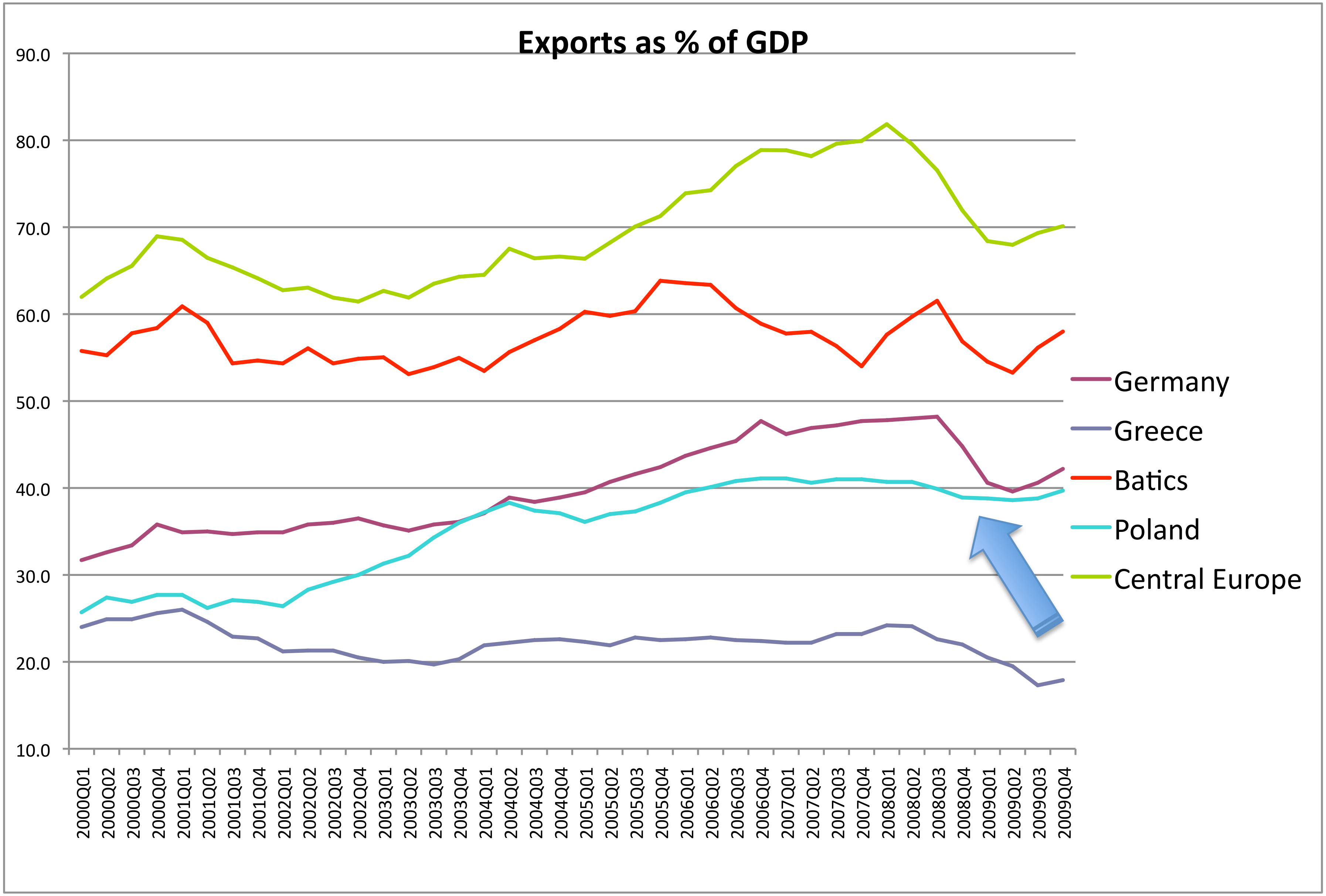
- Transformation of domestic banking
  - Forex lending to households, mortgages
  - Severing linkages with production sector
- Lagging productivity due to specialization into low value added production activities
  - Low domestic linkages
  - Weak knowledge production
- Loss of competitiveness through rapid currency appreciations

From emerging economic powerhouses to Ponzi schemes

- On the eve of the crisis, large foreign financing gap (current account balance + FDI), esp in the Baltics where it reached up to 10% of GDP
- Slowing cross-border flows, fdi and exports in 2008 and 2009, turned in particular the Baltics into Ponzi schemes with relatively weak social safety nets
- Foreign ownership of banks that fed domestic bubbles seems to have slowed down financial flow reversals, plus banks benefit from their domestic bail-outs/stimulus



Baltics are Estonia, Latvia, Lithuania; Central Europe are Czech Republic, Hungary, Slovenia and Slovak Republic; simple averages; calculations by the author



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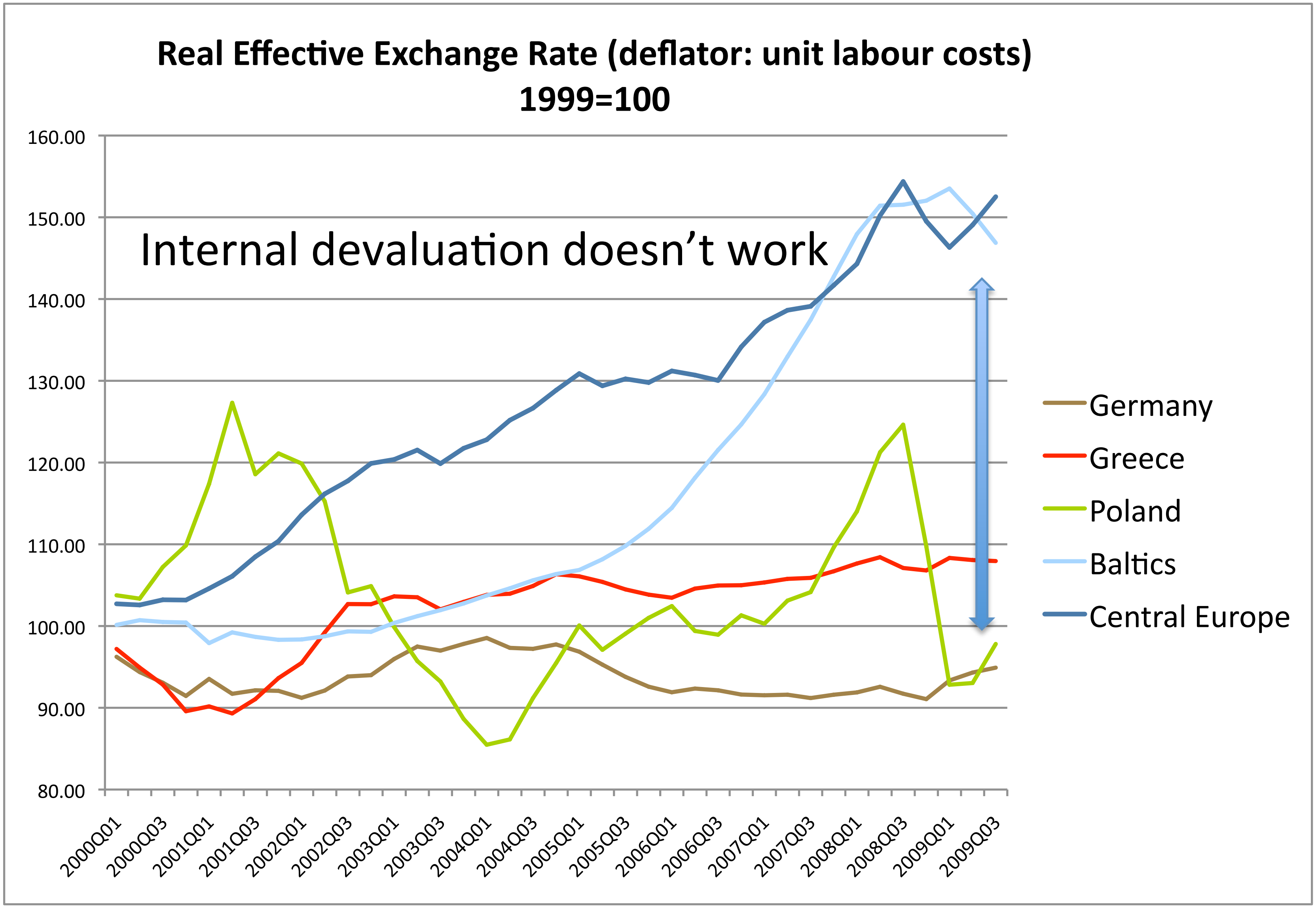

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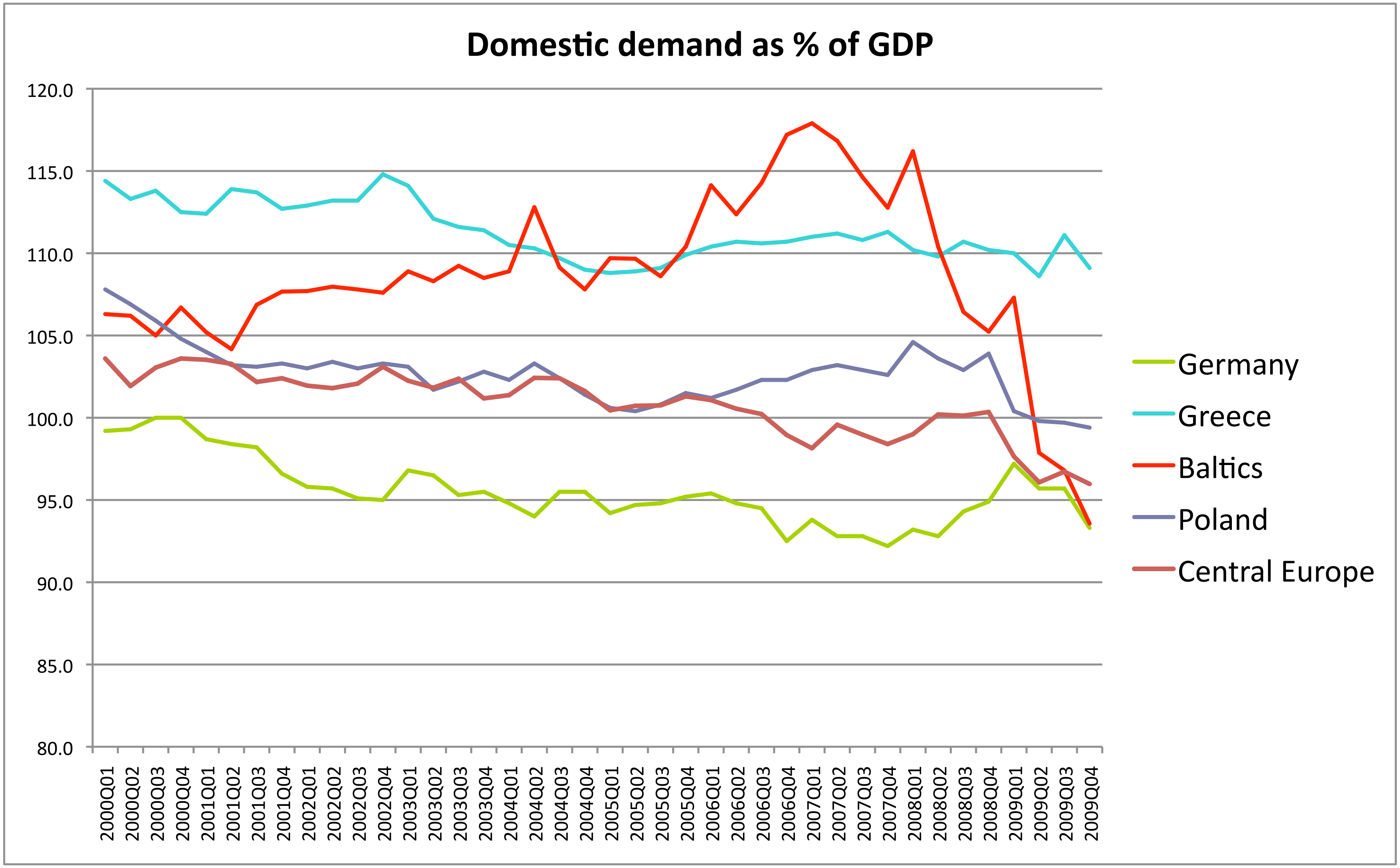

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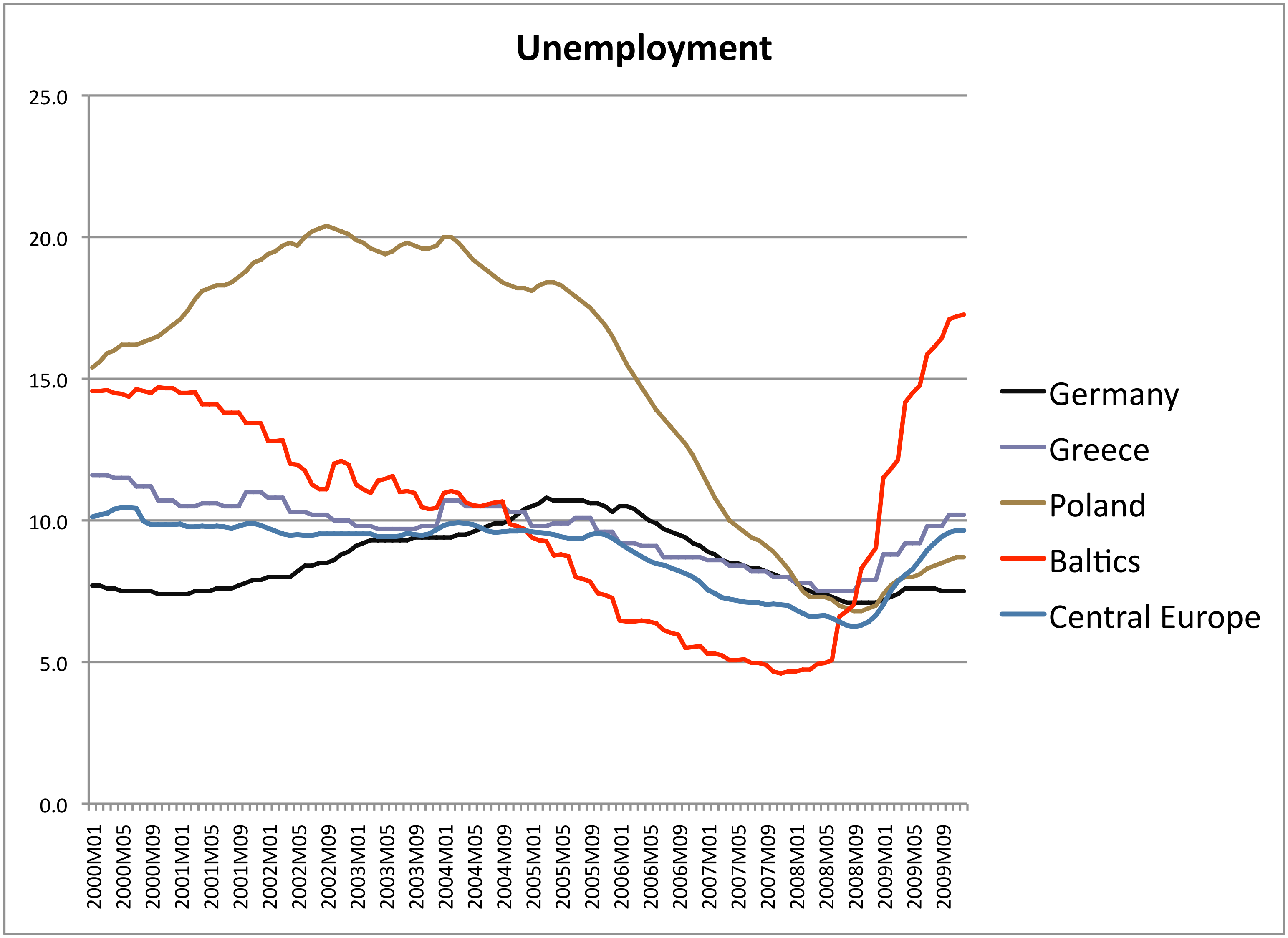

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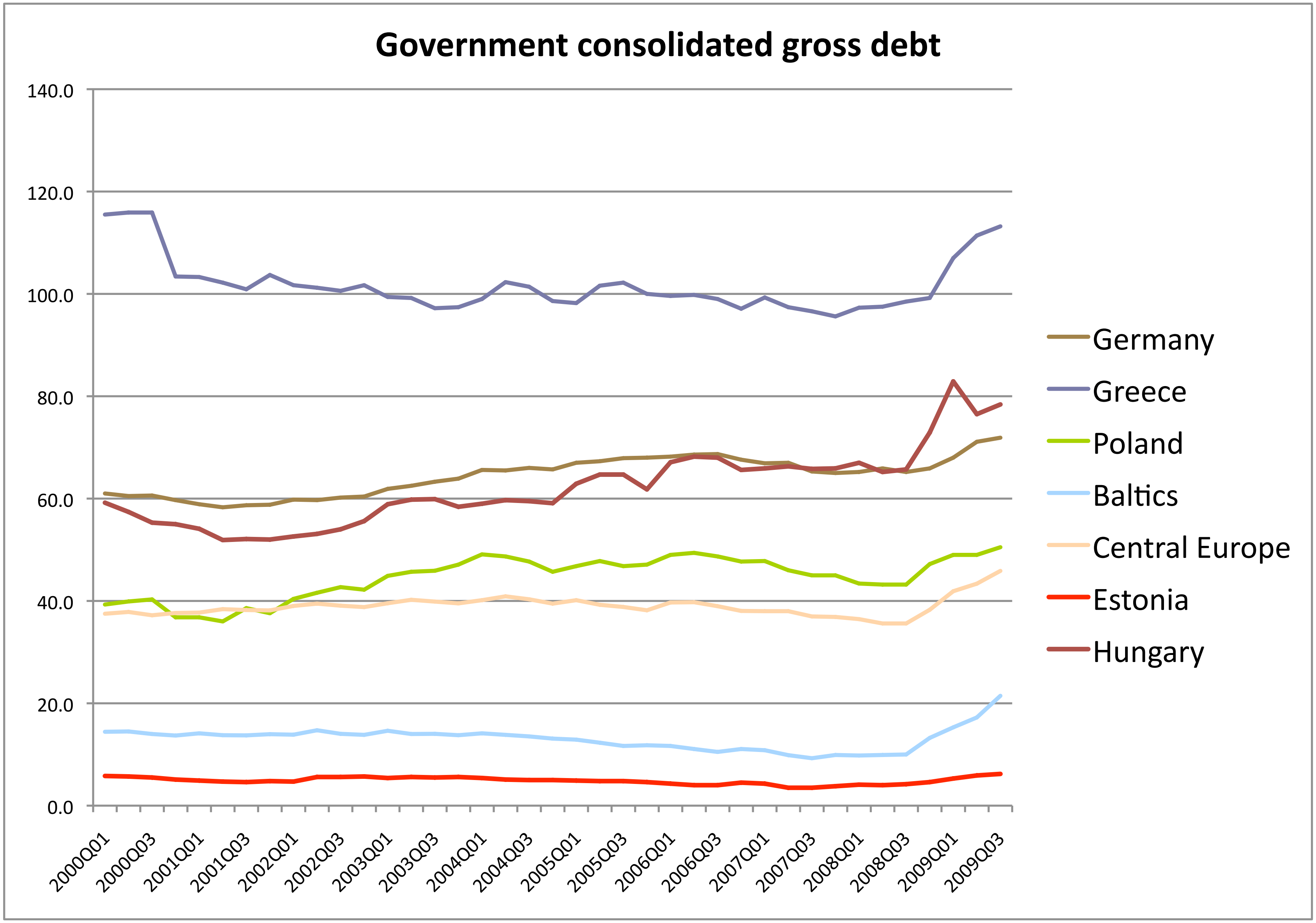

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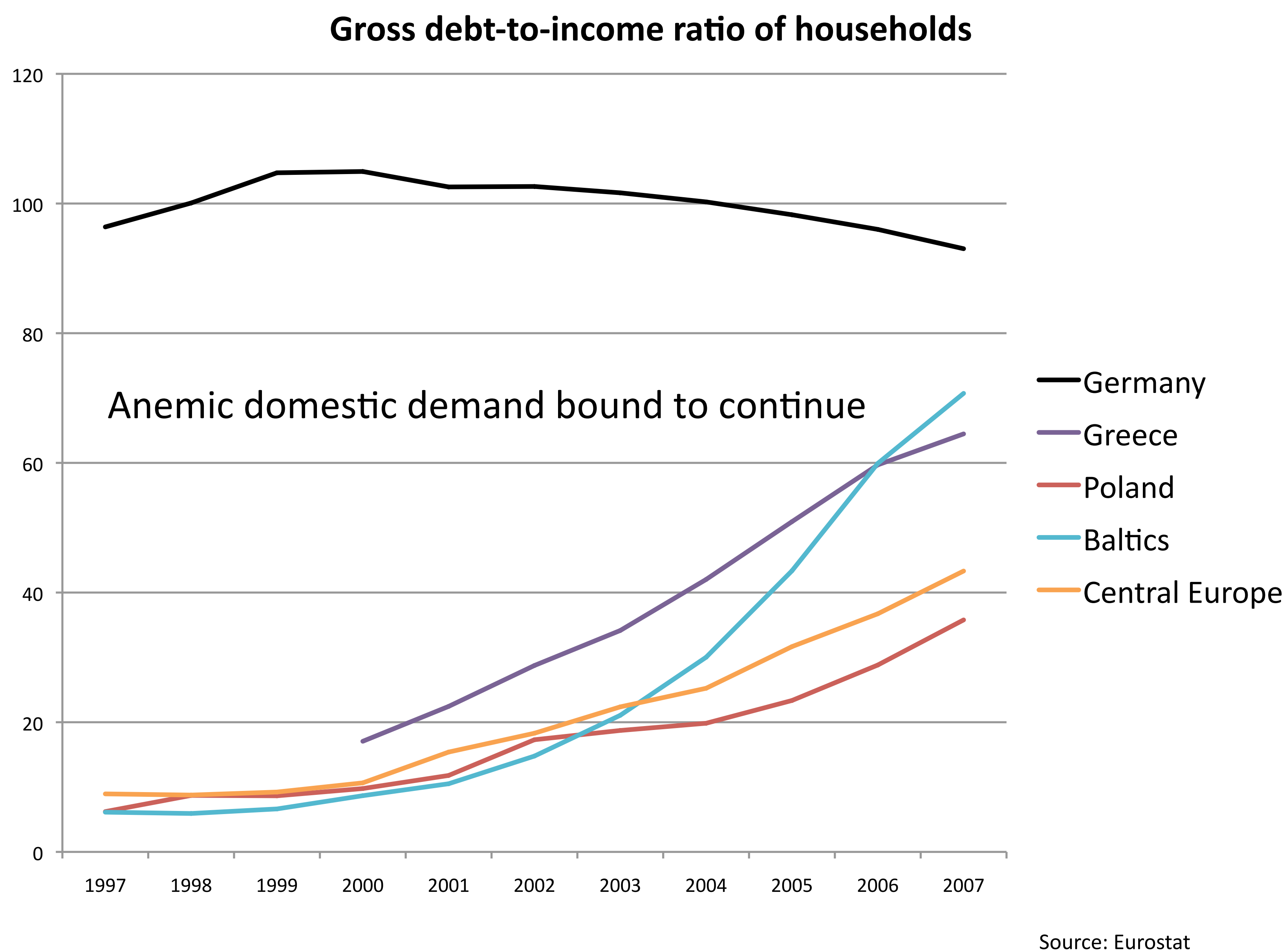
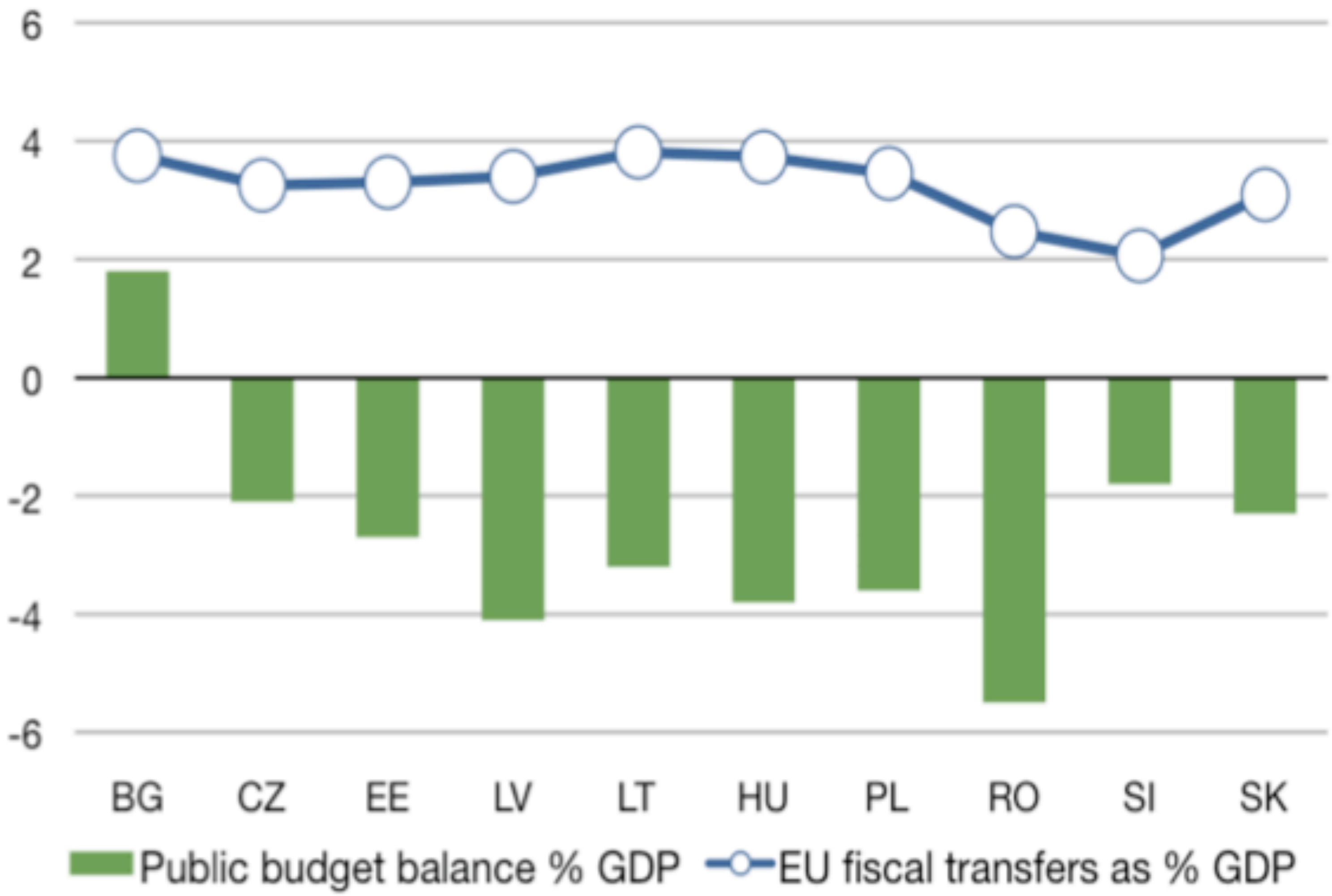
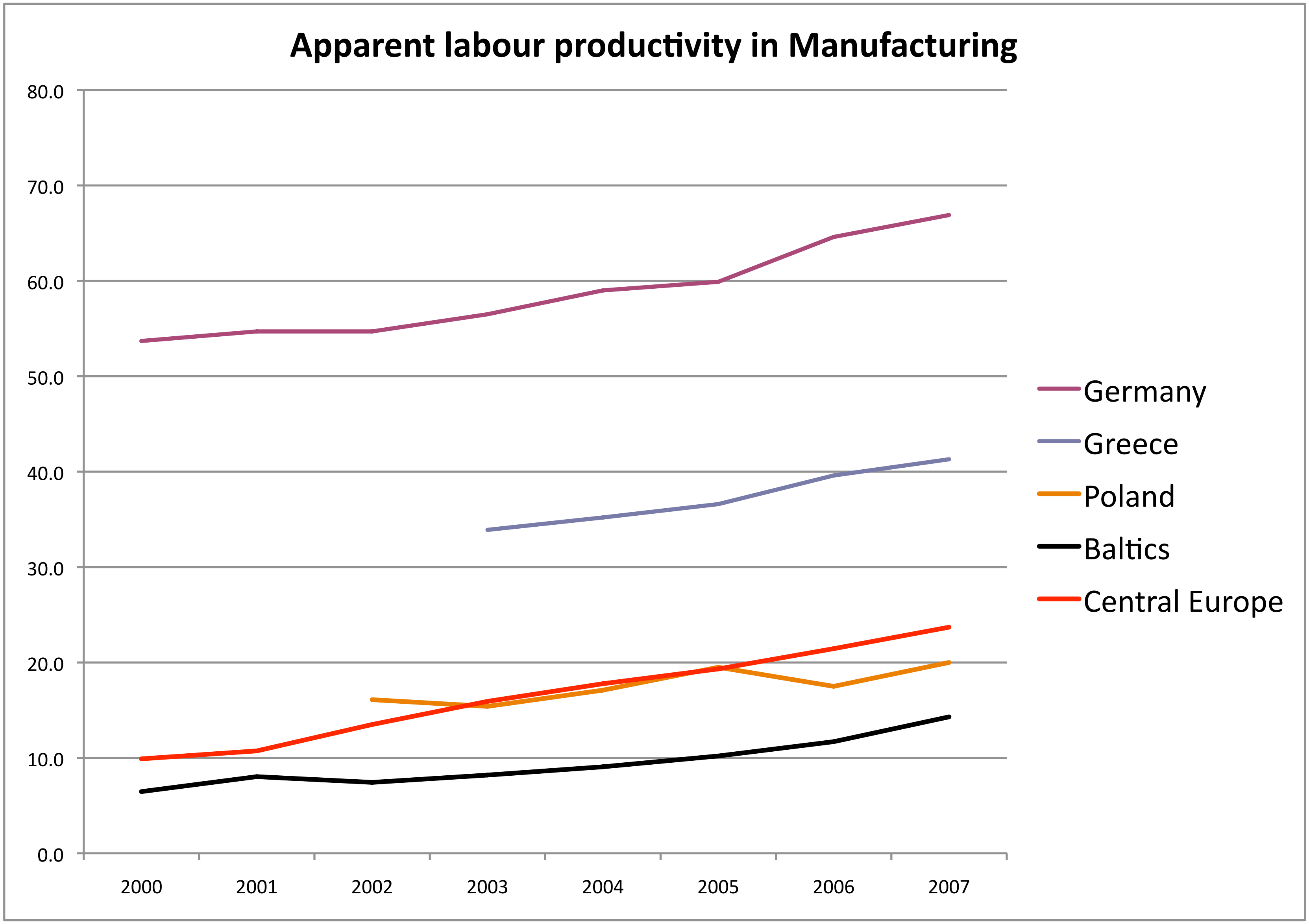


Gross debt-to-income ratio of households
120
100
80
60
40
20
0
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
Anemic domestic demand bound to continue
Germany
Greece
Poland
Baltics
Central Europe
Source: Eurostat

Public balance as % GDP and fiscal transfers from the European Union, 2008



Source: Fiscal transfers from the European Union are annual transfers through the so-called structural funds. Here, the EU fiscal transfers include funds from three main sources: Cohesion, Rural Development and Fisheries Fund; calculations by the author. Unemployment figures are from September 2009.



Source: Eurostat

*Baltic economies are mirror images of the PIIGS: both regions express similar woes differently disguised, partially engendering from the current EU macroeconomic framework and production network integration

*In the former, the private sector carries the cost of the crisis, in the latter mostly the public sector (social safety nets); because of the in-built inflexibilities, both are cases of free riding: the former postpone costs and export public deficits, the latter unemployment to the rest of Europe

*Central European economies, except Poland, seem to follow Germany (weak domestic demand, high levels of exports) through high level of integration into latter's production networks – danger of low productivity trap a la PIIGS; Baltics and Central Europe are Greece in disguise

*Poland, with floating currency and relatively large domestic market, seems to be faring the best so far among Eastern European economies