The Effects of the Global Financial Crisis on the Central and Eastern European Union Countries

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Abstract

After a period of strong expansion of economies across the world, in 2007 a crisis burst out in the real estate sector of the United States. With the collapse of Lehman Brothers in 2008 the crisis soon became global. Initially, it primarily affected the advanced economies of the United States and Western Europe, but the spillover of the crisis was unexpectedly powerful. The financial crisis has hit the various Member States of the European Union to a different degree. The global financial crisis affected the real economy in Central and Eastern European Union countries such as Czech Republic, Estonia, Latvia, Lithunia, Hungary, Poland, Slovenia, Slovakia, , Romania and Bulgaria through two main perspectives. First, the credit squeeze affected borrowing conditions for firms and households with subsequent adverse effects on domestic investment and consumption demand. Second, the downturn in the global economy, affected export demand severely. In this study the effects of the global financial crisis on the new European Union countries, how this question is handled by the European Union and which strategies are followed for crisis management will be discussed.

Keywords: global financial crisis; central and eastern European Union countries; real GDP growth; uemployment rate;general government revenues; general government expenditures; net consolidated government lending

Introduction

Financial crisis - the economic situation that is related to the banking panic, which includes significant production and financial sector losses, causes chaos on international markets, creates the stock market's downfall, financial bubbles, currency crises, and foreign loans, leads a sharp decline in economic activity and has a potential to cause an economic recession. The most common financial (economic) crisis occurs when certain financial institutions or funds invested in financial assets lose most of their value. Then international investors conducted their own funds to withdrawal from a country that may cause loss of confidence both in the country's economy and country's national currency. Most of the financial crises and recessions arised in nineteenth and twentieth century resulted and have been identified with the banking sector scare, the bursting of the financial asset - stock, commodity or real estate - bubbles. The current global financial crisis started in mid-2007 and had affected the whole world by September 2008. It is global, has engulfed almost every country and is stronger in intensity and coverage than of earlier crises such as Great Depression of 1930's and South East Asian Crisis in 1997. (Dhameja, 2010)

Although the types of economic crisis, the reasons and circumstances in different countries in different periods are different, there can be found crises' common denominators and learnt from past mistakes. Monitoring of relevant macroeconomic variables, comparing them with the theory of the trends can provide early warning of impending crisis. Often there is a problem to select markers or macroeconomic indicators that could indicate economic crisis in advance. However, quantity of variables and their qualitative characteristics help to form a reliable picture of the country's economic situation. Conclusions and forecasts make a significant impact on future economic policy, which could help to avoid the negative impact of the crisis, or even avoid the crisis itself. In order to increase the efficiency in the financial markets and enhance the economic growth, policies for financial stability as well as for price stability should be implemented. (Manescield, 2006)A successfully functioning financial sector is an important condition for the growth of economy in every country. (Lakstutiene, 2008)

If a country's financial sector is not functioning smoothly, then a financial crisis occurs. Financial crisis triggers economic consequences of inflation, unemployment, drop in purchasing power, growth of public debt as the government may have to devalue national currency or to borrow from the International Monetary Fund and others. Importance of the stability of financial system becomes very significant when a country's economy faces the crisis. The financial crisis is not just a phenomenon of recent decades. Each country specific fluctuations in the economy are known as the economic upswing and downturn. When the prolonged downturn proceeds, it is said that a very serious crisis occurs.

The Global Financial Crisis and the Central & Eastern European Union Countries

The global financial crisis has significantly affected the European Union, especially the new members such as Czech Republic, Estonia, Latvia, Lithunia, Hungary, Poland, Slovenia, Slovakia, Romania and Bulgaria. Reasons and circumstances of economic crisis in different countries in different periods are different. The global crisis supports the idea that the regional economies, even European Union (EU27) or USA, are not able to face to the new challenges. (Romeo, 2010) As a result, every EU Member State tries to face to this crisis as well as possible. The diversity of the economic and financial environment, economic characteristics and economic policy objectives determines the different measures need to overcome the crisis.

In Central Europe, Hungary is performing abysmally. It does not just suffer from the recent general crisis, but also from erroneous policies in the past. Due to a political stalemate, budget deficits have risen enormously over the last years. The Hungarian forint rapidly lost its value since the autumn of 2008 and, therefore, it is becoming harder and harder for Hungarians to service mortgages that were set in Swiss francs. On top of that, since interest rates on Swiss credits were low, many Hungarians also borrowed francs for private consumption. Hence Hungary is facing hard times, which manifests itself in a substantial negative growth of GDP (26.5 % in 2009) and declining creditworthiness. (European Bank Report,2009)

Slovenia, Slovakia and the Czech Republic are maybe in a slightly beter position for different reasons. Slovenia and Slovakia benefit from having the euro. It gives the countries better credit ratings. At the same time, this seems to be offset by severe losses in export markets. A relatively expensive euro makes these countries less attractive. Being the largest car producer in the world (over 100 cars per 1000 inhabitants in 2008) and exporting 90% of the produced cars, Slovakia severely suffers from the global decline in car sales.(Hoen, 2009) The Czech Republic does not suffer from expensive exports, but lacks the standards of Slovenia's and Slovakia's creditworthiness. That may have consequences for attracting foreign direct investments.

Poland is the genuine exception in Central Europe. For quite some time now, it meets the conditions of the stabilization pact and, therefore, has low budget deficits and moderate inflation. However due to the fact that it did not join the euro, it could benefit from a cheap zloty. Even as a large steel producer, Poland was able to expand it exports. Given the fact that the global demand declined dramatically over the last two years, it implies that this transition country has gained market shares. (European Bank Report, 2009) In South-Eastern Europe, all the countries are hit disproportionately by the recession. Declining economic activity replaces a period of excessive growth. Bulgaria is the only country that is able to sustain its relatively favourable credit ratings, thanks to its currency board.

The Baltic states really suffer from the crisis and perform badly. Estonia was the first member-state of the EU that suffered from a recession and, due to popular unrest, Latvia was urged to ask for IMF-support.(www.imf. org, 2010) Within these countries, the shadow side of a currency board showed itself. When operating with such an exchange-rate regime, governments cannot opt for monetary financing and, consequently, one is forced to rely upon private credits. This has been done on a very large scale, with all the well-known negative consequences. The economies have tremendously deteriorated and now experience a collapse that is comparable to that at the beginning of the 1990s, right after independence.

The economic downturn has precipitated Lithuanian economy to the moment almost four years ago. This is also reflected on the forecasted macroeconomic indicators. In just a few quarters Lithuania's economy has suffered a severe and sudden downturn and projected economic slowdown became a sharp decline. However, if Lithuania is able to overcome the challenges of the crisis and to carry out painful but necessary structural reforms it will create a strong foundation for long-term competitiveness. In particular, these factors and sustainable growth of Lithuanian purchasing power should lead to the bright potential of our country's economic prospects in the long term.

Nowadays Lithuania's economy is facing its deepest recession since the independence was regained. When the economy is slowing down, the sales and production in majority of economic sectors decline, and unemployment increases simultaneously. Depression involved all three markets: goods and services, resources and finances. (Racickas and Vasiliauskaite, 2010) The main economic cause of the crisis originated in Lithuania – is the external force and the rapid expansion of lending volume during the pre-crisis period, which allowed the emergence of real estate and stock market bubble. Lithuania seeks to integrate into the Euro zone, so there is a need to maintain a stable exchange rate. Meanwhile the state could expect the European Community institutional support, if the crisis was a long process and did significantly affect the country's economy. On the other hand, due to the fixed exchange rate one of the ways to raise the competitiveness of export markets is lost and to attract funds from financial markets is very expensive way.

One of the few solutions Lithuanian government now has is saving. Undoubtedly, one of the theoretical methods of implementing government's commitment is to devalue country's national currency. Unfortunately, this is only a last resort and under-effective tool because it would improve state of exporters only for a short period of time. Meanwhile, in the long term, the country's economic situation would only further be destabilized. Due to the price rise for imports of strategically important raw materials country's current account deficit would increase, and traders on the foreign currency debt would incur more harm than good. At the end of the financial crisis, some of the Central and Eastern European countries such as Lithuania may face a long economic depression. It might take long for the end and the break of Lithuanian stock market downturn. Besides more severe economic recession, the global financial crisis impact on Lithuanian economy will be greater due to Lithuanian stock market's dependence on foreign institutional investors.

According to the technical definition of a recession, namely a decline in GDP for two consecutive quarters, Romania has entered recession in 2009. During the first quarter of 2009 the gross domestic product of Romania fell by 2.6 percent compared to fourth quarter of 2008 and 6.4 percent compared to first quarter 2008. The fourth quarter of 2008 witnessed a reduction of gross domestic product by 3.4 percent over the third quarter. The second quarter of 2009 saw another decline of GDP, by 1.1 percent compared with the previous quarter and by 8.8 percent compared with the same period of 2008. (Zaman and Georgescu, 2009) Currently, the government is forced to ask for help everywhere; several international organizations started to pump money in the economy, which was considered half a year ago by its authorities as being the economic tiger of Europe. (Zaman, 2009)

In order to analyze financial crisis impact on countrys' economy, following key macroeconomic indicators will be used:

- Real GDP Growth
- Unemployment Rate
- General Government Revenues, Percent of GDP
- General Government Expenditures, Percent of GDP
- Net consolidated Government Lending, Percent of GDP

Table 1: Real GDP growth percent per year in the Central and Eastern European Union countries, 1995–2009

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009*
Bulgaria	..	–9.4	–5.6	4.0	2.3	5.4	4.1	4.5	5.0	6.6	6.2	6.3	6.2	6.0	–5.9
Czech Republic	..	4.0	–0.7	–0.8	1.3	3.6	2.5	1.9	3.6	4.5	6.3	6.8	6.1	2.5	–4.8
Estonia	2.8	5.7	11.7	6.7	–0.3	10.0	7.5	7.9	7.6	7.2	9.4	10.0	7.2	–3.6	–13.7
Latvia	0.5	3.6	8.3	4.8	3.3	6.9	8.0	6.5	7.2	8.7	10.6	12.2	10.0	–4.6	–18.0
Lithuania	..	5.2	7.5	7.6	–1.1	3.3	6.7	6.9	10.2	7.4	7.8	7.8	9.8	2.8	–18.1
Hungary	..	1.0	4.3	5.2	4.2	4.9	4.1	4.4	4.3	4.9	3.5	4.0	1.0	0.6	–6.5
Poland	..	6.2	7.1	5.0	4.5	4.3	1.2	1.4	3.9	5.3	3.6	6.2	6.8	5.0	1.2
Romania	..	..	..	..	–1.2	2.4	5.7	5.1	5.2	8.5	4.2	7.9	6.3	6.2	–8.0
Slovenia	6.8	3.6	4.9	3.6	5.4	4.4	2.8	4.0	2.8	4.3	4.5	5.8	6.8	3.5	–7.4
Slovakia	7.9	6.9	4.4	4.4	0.0	1.4	3.4	4.8	4.7	5.2	6.5	8.5	10.4	6.4	–5.8
EU15	..	1.7	2.7	3.0	3.0	3.9	1.9	1.2	1.2	2.3	1.8	3.0	2.6	0.6	–4.1

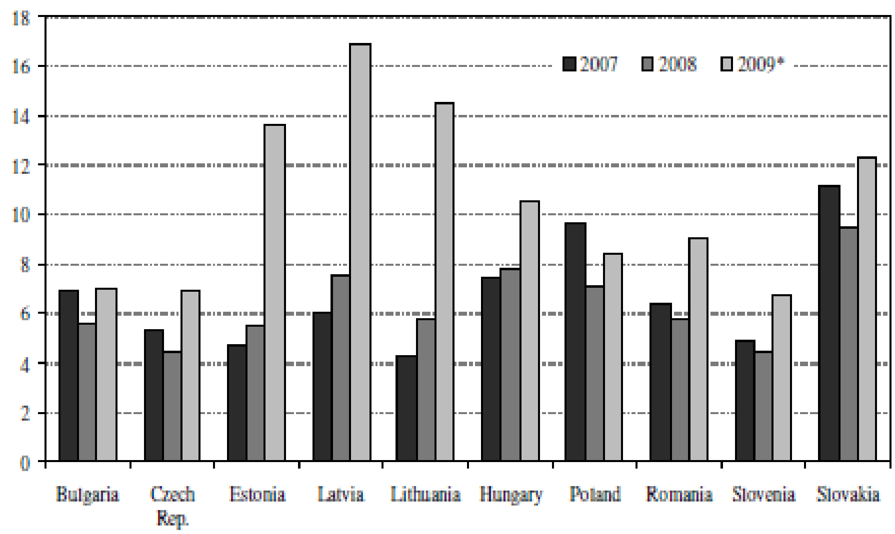
Source: Eurostat Statistics, 2009

Table 1 shows the real GDP growth in each of the 10 new EU countries from 1995 to 2009, where the 2009 data are estimates produced by the European Commission and published in November 2009. Until the outset of the global financial crisis, the growth rates in the new EU countries generally exceeded the EU15 average, reflecting a catch-up process where the new EU countries with relatively low initial income levels have been narrowing the income gap to the more developed old EU countries. It is noticeable that economic growth accelerated in most of the new EU countries in the run-up to the EU accession in 2004 or 2007, the prospect of membership instilled confidence among financial markets participants and led to substantial capital inflows.

The (estimated) GDP growth in 2009 is depicted in the last column of Table 1. There are substantial differences in output performance across the 10 countries. The three Baltic States stand out with double-digit GDP falls in 2009. The remaining Central and Eastern EU countries all exhibit estimated GDP declines ranging from 5 to 8 percent in 2009. Econometric analyses based on cross-sectional datasets suggest that the GDP declines resulting from the global financial crisis were largest in countries with highly leveraged financial systems and rapid credit growth prior to the crisis (Berkmen et al., 2009). A larger share of foreign bank ownership appears, however, to have mitigated the GDP decline (Berglof et al., 2009). There may also have been a tendency for countries with inflexible Exchange rate systems and large foreign trade to have suffered larger GDP declines although these results seem to hinge on the particular choice of countries in the sample (Berkmen et al., 2009).

The unenviable output performance in 2009 should be seen in light of the preceding high growth rates. The Baltic States have, for instance, seen reversals of GDP growth from 2007 to 2009 amounting to 20–30 percentage points. Other countries have seen reversals during the same time interval of the magnitude 5–15 percent points. The downturns are distributed unevenly across individuals and are certain to entail substantial social costs in the form of higher unemployment and increased poverty rates.

Figure 1. Unemployment Rate

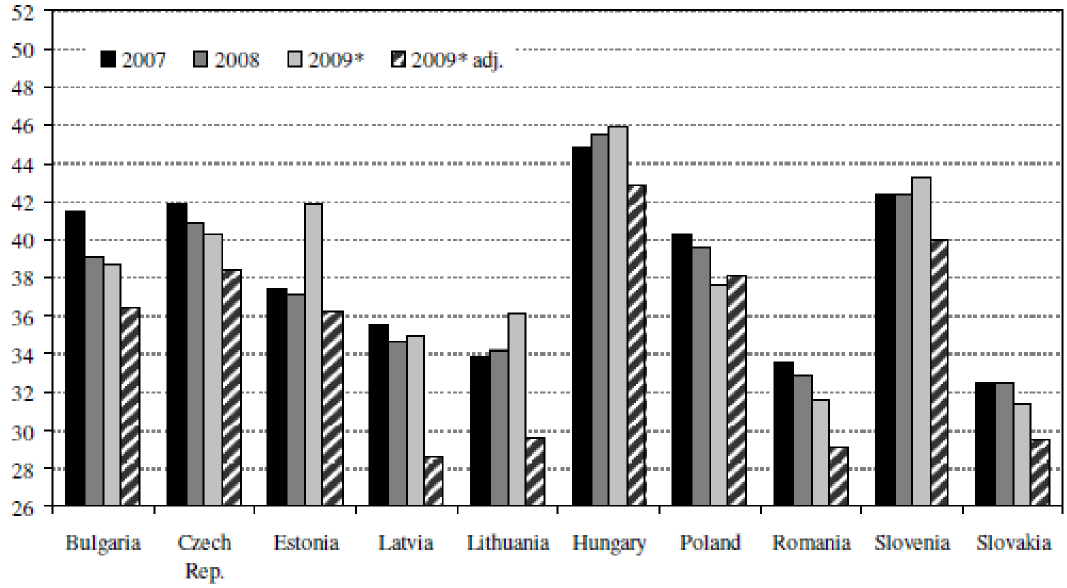


Source: Eurostat Statistics, 2009

Figure 1 shows the unemployment rate for each of the 10 countries in 2007 and 2008 and the estimated unemployment rate for 2009. The unemployment increases in the Baltic States are remarkable, but all countries in the region have seen increasing (estimated) unemployment in 2009 and the European Commission forecasts the increase to continue in 2011.

The immediate financing concerns in autumn 2008 and at the beginning of 2009 were followed by concerns regarding the overall budgetary stance. It is noticeable that the direct budgetary impact of the financial crisis has been modest in most countries as no major financial sector bailouts have been undertaken, except in Latvia. Thus, the impact of the global financial crisis on public finances in the 10 new EU countries has primarily been indirect through the derived effects on economic activity, interest rates, unemployment, etc. The tables below focus on developments in the main budget items, i.e. revenues, expenditures and the budget balance.

Figure 2: General government revenues, percent of GDP, 2007-2009

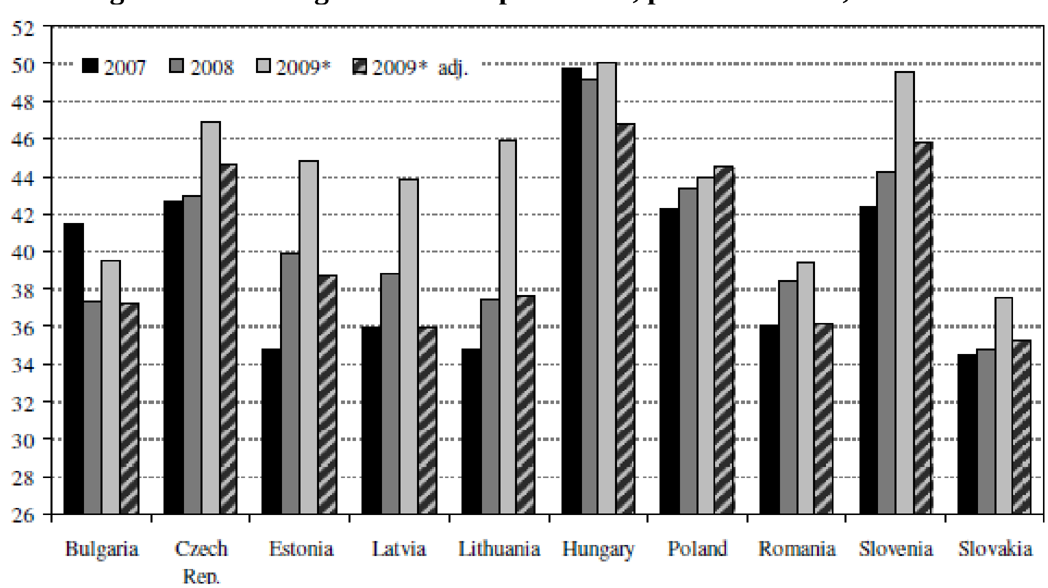


Source: Eurostat Statistics, 2009

Figure 2 shows the general government revenue as a percent of GDP for 2007–2009, where the 2009 data are estimates by the European Commission based on statistical information from a large part of 2009. For 2009 the measure is greatly affected by GDP falling rapidly in almost all countries, which "mechanically" increases the government revenues as a percent of GDP if real (price deflated) government revenues remain unchanged. We therefore also include an adjusted 2009 revenue share, which is computed as the 2009 revenue share multiplied by one plus the real GDP growth rate for 2009. If the price indices of GDP and government revenues coincide, the adjusted revenue share is simply the 2009 revenues divided by GDP in 2008.

Government revenues as a percent of GDP were broadly at the same level in the three years under review, with the main exception being Estonia, where revenues *increased* markedly in 2009 as a percent of GDP. Estonia adopted aggressive revenue enhancing policies including higher unemployment insurance contributions, divergence of pension contributions from private pension accounts to the budget, a higher value added tax rate, higher excise taxes on energy, alcohol and tobacco as well as some one-off transfers from stateowned companies (IMF, 2010).

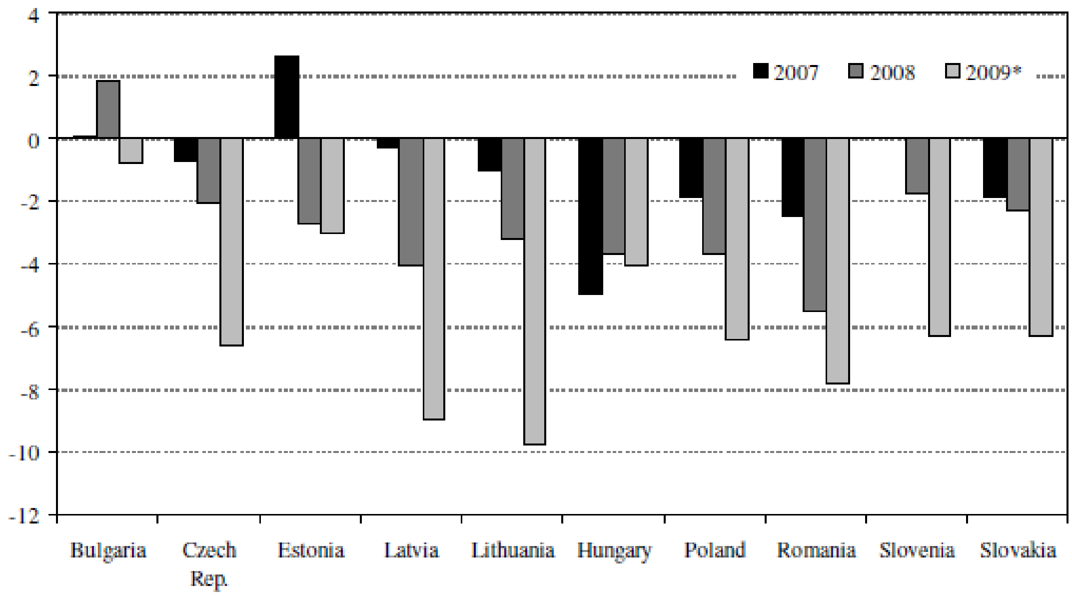
Figure 3: General government expenditures, percent of GDP, 2007–2009



Source: Eurostat Statistics, 2009

Figure 3 shows the general government expenditures as a percent of GDP for the new EU countries for 2007–2009; as before the expenditures for 2009 are also computed as a share of GDP for 2008. All countries in the region exhibit increasing expenditures as a percent of GDP from 2008 to 2009 and the increase is substantial for many countries. However, comparing the change in real expenditures from 2008 to 2009, it follows that most of the new EU countries kept government expenditures in real terms largely unchanged during the first year of crisis.

Figure 4: Net consolidated government lending, percent of GDP, 2007–2009



Source: Eurostat Statistics, 2009

Finally, Figure 4 shows the net effect of the changes in revenues and expenditure discussed above, i.e. the headline consolidated government budget balance for 2007–2009. The budget balance worsens in all cases from 2008 to 2009 and is estimated to exceed 6 percent of GDP for 7 out of the 10 countries. The deterioration of the budget from 2008 to 2009 is most dramatic for Latvia and Lithuania, but also very substantial for the Czech Republic, Poland, Romania, Slovenia and Slovakia.

Conclusion

The EU policy framework for crisis management largely builds on existing institutions and procedures, but parts of it are emerging from the various policy actions during, and prompted by this crisis.(Economic Crisis in Europe: European Commision, 2009) In line with European Union recommendations, the Euro area –has chosen a comprehensive approach of state guarantees, public bank recapitalization and stimulus spending going hand in hand with measures by the European Central Bank to provide liquidity to the markets, reducing the ECB policy rate to historical lows. (Dietz and Protsyk, 2009) The crisis has exacerbated strains within the euro area. Many of the euro area's 16 member countries have been running large current account and fiscal deficits, coupled with anemic growth and high debt ratios. These countries are now suffering from more difficult financing conditions and even worse growth prospects. (Belka, 2009)

Many governments needed to receive different types and amounts of economic support to avoid serious damage. With this crisis, the question how the member states of the European Union can take measures independently is brought to the agenda, as their economies have been connected to each other for fifty years with the attempt to integrate. (Tezcan, 2009) It is possible to divide the 10 new EU countries into four different groups based on their short-term fiscal policy response to the crisis.

1) Latvia, Hungary and Romania encountered serious financing problems and had to turn to the IMF for support. The countries have seen contracting revenues in real terms, but also managed to lower real expenditures in 2009. In this group, Hungary has been most successful in curbing the budget deficit.

2) The Czech Republic, Poland, Slovenia and Slovakia have deficits of 6–8 percent of GDP in 2009. The deficits are largely the results of relatively expansionary expenditure policies. The latter two countries have arguably been aided by their membership of the EMU, which has helped reduce their exchange rate exposures and increase investor confidence.

3) Bulgaria and Estonia have retained a high degree of budgetary discipline and attained budget deficits in 2009 at or below 3 percent of GDP in spite of substantial GDP declines.
4) Lithuania is an "outlier" in the sense that it has seen a very large GDP fall in 2009, but has still managed to finance its very substantial deficit without turning to the IMF. (Staehr, 2010)

As a result of the global crisis, in 2008 and 2009 three EU members—Hungary, Latvia, and Romania—faced balance of payments crisis so severe that they required external financial assistance. In each case assistance was provided in the context of joint IMF/EU balance support program. One country, Poland, while less vulnerable, decided to avail itself of the IMF's new contingent credit line, the FCL, and thereby reassure international capital markets that its liquidity remained assured. The IMF's initial crisis response for EU members has been fast and efficient, later developments reflected country specific issues. In October 2008 the Hungary crisis was – at the time—unexpected. Yet, the response was efficient: in the absence of a precedent the IMF and EU agreed in an unbureaucratic manner to undertake a joint program The program was agreed in "record time" and in an amount set to not only ensure bop sustainability but to avoid second round speculative attacks, and thereby to ensure instant credibility. Similar approaches led to rapid disbursements also for Latvia and Romania when these countries faced crises shortly thereafter, and, in particular in Latvia, helped prevent a major balance of payments crisis. Following the initial disbursements, developments in the three crisis countries differed significantly. While initial developments in Hungary and mostly also in Romania tended toward stabilization, the most dramatic developments clearly occurred in Latvia. In this context the first review of the program was delayed by several months as a result of the deepening economic crisis and a lack of full policy support for the necessary reform measures. The credibility of the program and the stability of the country was at stake.

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