EUROPE

Losing Their Halo

Many countries in central and eastern Europe are finding it hard to adjust to the new economic reality

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THE new central and eastern European members of the European Union had it very good for a while. EU membership spurred economic and financial integration, leading to rapid economic growth and large capital inflows. It also created a "halo effect," shielding some countries from paying more to borrow external funds in spite of growing vulnerabilities.

But the good times didn't last. The new member states' initial resilience to the global financial turmoil gave way to deep crisis in a few of them. When the global crisis hit in 2007, emerging Europe initially seemed immune because it did not have direct exposure to U.S. subprime assets. But as the crisis deepened in 2008, exports slowed and capital inflows came to a virtual standstill in some countries. Unfortunately, the economic and financial integration that had helped emerging Europe catch up with advanced Europe during the good times made them more vulnerable as the global economic climate worsened.

The new EU members must now not only overcome the current crisis but also build on the gains of recent years. They need to put in place more prudent policies and stronger policy frameworks, especially with respect to fiscal policy and financial supervision. And they must do so in a far more difficult global economic environment. The good news is that the flexibility of their economies may help them adjust more quickly than the more advanced European countries.

Catching up, and fast

The accession of eight new member states—the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia—to the European Union in 2004 represented the biggest ever enlargement of the European Union in terms of population (19 percent) and area (22 percent), but a smaller increase in terms of economic output (9 percent). Two more countries from the former Soviet bloc, Romania and Bulgaria, joined in 2007. For all these countries, EU membership represented a major milestone in their transformation to market-based economies.

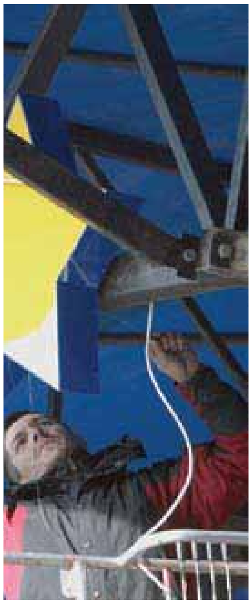
Increased economic integration and successful reforms fostered faster than expected growth in the new member states—by 1 percent, on average—given their economic fundamentals (see Chart 1). This rapid growth allowed the new EU countries to increase their share in global economic output. Greater access to western markets led to a rapid rise in exports and improved access to foreign financing helped boost consumption.

EU membership has been particularly favorable for Slovenia and the Slovak Republic, which have managed to meet all of the Maastricht criteria and enter the euro area. Slovenia was the first new member state to adopt the euro, in January 2007. The country's per capita income, the highest among the new member states, reached about 80 percent of the EU average in 2006, putting it on a par with Greece and above Portugal. The Slovak Republic, the most recent entrant to the euro area in January 2009, has been one of the strongest economic performers among the new member states, with growth fueled by productivity gains and exports. Together with Slovenia and the Czech Republic, it is now considered an advanced, rather than emerging economy.

Tiger in the tank

The new EU states' relative success in stabilizing and reforming their economies, combined with their acceptance into the European Union, appears to have contributed to rapid interest rate convergence, even though favorable global conditions—low interest rates, ample liquidity, and a widening of the investor base for emerging markets—also played a role. This spurred massive capital inflows to the new member states, in the form of direct investment, bank loans, and portfolio investment.

Today, the share of foreign ownership in the banking systems of emerging Europe is higher than in advanced Europe and in emerging markets in other parts of the world. A handful of foreign banks, headquartered in advanced Europe, entered the new markets in emerging Europe mainly by acquiring newly privatized banks. These foreign banks currently control a major part of banking assets in the new member states (see Chart 2). The fact that foreign-owned banks



could potentially tap into the larger pool of capital available to their foreign parents provided comfort to other foreign investors in the region. Whether this will continue to be the case remains to be seen.

Capital inflows into banks were accompanied by rapid credit growth, although the speed of this growth differed among new member states. While the three Baltic countries recorded credit growth rates well above comparable countries, rates in most other new member states were broadly in line with their financial development. The rapid credit growth also led to substantial financial deepening in the new member states.

Overheating engine

But increased integration and the large capital inflows that followed also led to new vulnerabilities. The inflows contributed to high levels of external debt and excessive current account deficits in several new EU members (see Chart 3). Rapid credit growth raised concerns about overheating as inflation increased, current account deficits widened, and housing bubbles inflated. The concern about balance sheet risks was especially pronounced in countries where people and businesses were taking out loans in euros and other foreign currencies (mainly Swiss francs and yen) because this led to a buildup of currency mismatches. Indeed, the share of foreign currency lending in most new member states exceeded the levels of western European, Latin American, and East Asian emerging markets. Currency mismatches increased the private sector's vulnerability to exchange rate depreciation and built up banks' credit risk.

Higher financial integration also raised emerging Europe's exposure to risks originating elsewhere. Tighter linkages, which had previously lifted growth, could also heighten a slowdown. And although cross-border exposures by international banks, mostly from advanced European countries, helped increase financial intermediation, they also created new channels of contagion.

No longer special

Despite warning signals in the form of growing current account deficits and high levels of public debt, markets appeared to have underestimated the risks and maintained their exposure to central and eastern Europe. This reflected the markets' perception that, by virtue of their EU membership, these countries were likely to be bailed out in the event of a crisis. This perception meant that bond spreads reflecting country risk were lower than they would otherwise have been—what is known as the halo effect. Indeed, markets priced the sovereign assets of new member states some 50–100 basis points below the levels that would be expected based on standard macroeconomic fundamentals.

The onset of the global financial crisis changed everything, not least because it eliminated the halo effect and highlighted the differences among the new EU states (see Chart 4). Late in 2008, with shrinking exports to advanced countries and a sharp slowdown in capital inflows, the crisis spread virulently through emerging Europe. The cost of funding for all sovereign borrowers soared, and access was sharply curtailed. Although countries adhering more closely to the Maastricht criteria tended to face lower increases in spreads, they were not shielded completely.

The crisis brought increased scrutiny on external imbalances and domestic overheating of individual EU countries. The IMF's May 2009 *Regional Economic Outlook for Europe* shows that countries with higher inflation, current account deficits, and bank-related capital inflows were hit hardest. In other words, the risk of a sudden stop in capital inflows was at least as important as adherence to the Maastricht criteria for the initial impact of the crisis on individual countries.

Sharp slowdown

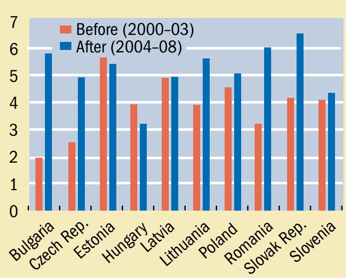
The financial crisis has resulted in a sharp slowdown in all emerging markets, including those in Europe, with the IMF's Spring 2009 *World Economic Outlook* forecasting a contraction of almost 3 percent for these countries in 2009. The new member states' vulnerabilities are worsened by macrofinancial linkages: a slowdown in income growth, interest rate and ex-

Chart 1

Boost to growth

EU membership sparked rapid catch-up growth in central and eastern Europe.

(GDP, average annual change, percent)



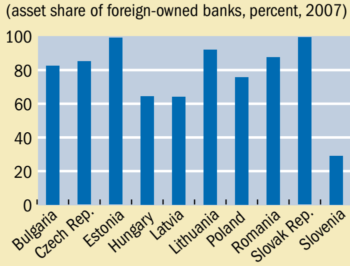
Source: Čihák and Fonteyne, 2009.

Chart 2

Controlling stake

Much of the banking system in central and eastern Europe is in the hands of western European banks.

(asset share of foreign-owned banks, percent, 2007)



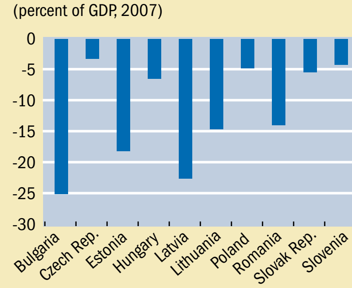
Source: European Bank for Reconstruction and Development.

Chart 3

Large imbalances

Many new member states developed sizeable current account deficits.

(percent of GDP, 2007)



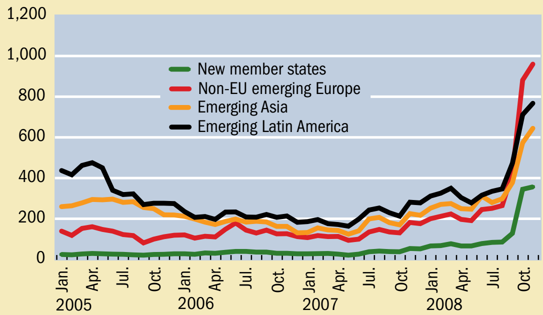
Source: IMF, World Economic Outlook database.

Chart 4

Losing the halo

Spreads on sovereign bonds in central and eastern Europe have started to rise, mirroring emerging markets elsewhere.

(basis points)



Sources: Bloomberg L.P.; and IMF staff calculations.
Note: Spreads in euros for new member states and non-EU emerging Europe; in dollars for all others.

change rate instability, and asset price corrections feed back into the financial sector. In response, the new member states have changed direction in the areas of monetary and exchange rate policy, financial sector policy, and fiscal policy.

Local currencies are looking increasingly vulnerable and governments are either unable, or finding it expensive, to borrow from the financial markets to finance their budget deficits. EU membership, however, has given emerging Europe access to some facilities that have proven useful during the crisis. One is the European Union's balance of payments facility, which has provided a safety cushion, and another is the establishment by the European Central Bank of repo arrangements with a few new member states. Hungary, Latvia, and Romania have requested financial support from the European Union and the IMF, and Poland has requested access to the IMF's Flexible Credit Line, a new facility designed for economies with a strong track record.

Stronger and leaner

Will the new EU member states emerge stronger from the crisis? In some ways, their economies are more flexible than those of advanced Europe, which may make it easier for them to adjust.

The crisis has put a higher premium on sound policies, and the adoption of EU-level frameworks appears to have contributed to sound macroeconomic and structural policies. This evidence is stronger for macroeconomic policies, where the Maastricht criteria and the Stability and Growth Pact have served as anchors for monetary and fiscal policy.

The Lisbon agenda—the EU's strategy for promoting growth and jobs—also seems to have had some impact in the new member states. The smaller EU members, and those with better fiscal performance, have shown greater progress on structural reform. Compared with advanced Europe, emerging Europe has less restrictive employment protection, lower minimum wages, less centralized collective bargaining, and less generous unemployment benefits.

Yet the disparity in outcomes among the new member states underscores that domestic policies are the critical drivers of economic performance. The crisis has amplified market perceptions of the differences across countries and has led to a repricing of risks in individual countries, as reflected in the increased dispersion of sovereign spreads.

The record on financial health in the new member states is mixed. Their banking systems have held up relatively well so far in the global crisis—with no systemic failures or generalized loss of depositor confidence. But prospects are challenging. Loan defaults are bound to increase as local currencies lose value and economies contract. Banks will have to cut back on credit because they failed to build buffers for bad times. Households will be unable to borrow from banks just when falling house prices and tighter economic conditions are squeezing incomes. Household consumption, averaging 60 percent of GDP, will undoubtedly suffer as a consequence.

What policies should the new EU member states adopt to get out of crisis? The banking sector was at the center of the crisis and so holds the key to recovery.

- Policies should include steps to support credit, for example through preemptive recapitalization of viable banks. Given that most of the banking sectors are foreign owned, attempts at recapitalization would be futile without close cooperation with supervisors of foreign parent banks.
- There is substantial scope for more effective supervision in individual countries under the existing financial supervisory frameworks. This includes, for instance, the possibility of imposing stricter capital requirements for weaker banks under the Basel II framework and adopting forward-looking provisioning policies for loan losses.
- The new EU members must safeguard the advances they have made in their financial policy frameworks and fortify them through stronger cross-border cooperation between home-host central banks, supervisors, and ministries of finance.
- Structural reforms should be intensified to prevent declines in long-run productivity and growth. Stronger policy institutions would ultimately reduce vulnerabilities associated with greater financial integration.

On all these counts, close cooperation between emerging and advanced Europe will be essential. The crisis represents an opportunity to solidify political, economic, and financial links in the region. But although strong EU policy frameworks can provide valuable support, the policies adopted by individual countries will ultimately determine how quickly emerging Europe recovers from what has turned out to be the worst crisis since the Great Depression. ■

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Reference:

Čihák, Martin, and Wim Fonteyne, 2009, "Five Years After: European Union Membership and Macro-Financial Stability in the New Member States," IMF Working Paper 09/68 (Washington: International Monetary Fund).