

Gligorov, Vladimir; Landesmann, Michael

**Research Report**

## The crisis in Eastern Europe: What is to be done?

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## What is to be done? A policy note

*Vladimir Gligorov and Michael Landesmann*

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### **Abstract**

*This policy note argues that the current global economic crisis enforces an adjustment process in the countries of Central, Eastern and Southeastern Europe (CEE and SEE) in the form of real exchange rate depreciation. Because of the weakness of financial institutions and built-up foreign currency debt such a process has inherent dangers to lead to overshooting and a possible capital flight out of these economies. In such circumstances the economies are severely constrained in putting the types of policies in place which are currently pursued in most of Western Europe, the USA and Japan, that is of backing up their banking system through recapitalization and through fiscal stimulus packages. Given the rather low levels of public debt in most of the CEE and SEE economies and the need to reinitiate the operation of the credit system, such policies have as much justification to be pursued in these economies as in the higher income countries. We hence advocate a determined approach by EU institutions and a coordinated approach by EU governments (in cooperation with IFIs) to back up a measured process of real exchange rate adjustment (in both flexible and fixed exchange rate countries) and to provide the backing necessary to pursue growth initiating policies in these economies.*

### **EU policy and Central and Eastern Europe**

The issue of crisis in the East is really about the ability of the EU to take on obligations in the areas covered by the common market principles irrespective of whether those are in one or the other region within the EU and even if some of those are spilling over to countries outside of the EU. The current crisis within the financial sector that is spilling over into the real sector is difficult to tackle because of the duality between common market policies and national structure of governance. One indication of this problem is the limited responsibilities of the Brussels' budget and another is the limited reach of the ECB in the domain of financial sector supervision. Other complications are connected with the slow process of euro enlargement, which has ramifications both for the euro zone and for the EU member states (as well as some non-member states) outside of that zone.

In that context, dealing with the current problems in the New Member States (NMS) and the Future Member States (FMS) are in part the responsibility of the EU, but cannot be addressed by the EU, at least not in a straightforward way. In the case of NMS, there is at least a forum to discuss these problems at, while in the case of the FMS (the group consists of candidate and potential candidate countries in the Balkans) there is little that can be done. Indeed, there is little public attention paid to this region. The crisis there, it may turn out, could have serious economic, social, and political consequences.

### **The adjustment**

What distinguishes the NMS and the FMS from most other countries afflicted with the economic downturn is the main channel of transmission of the crisis and the main instrument of adjustment. These countries have high or very high current account deficits and thus rely on foreign credit or investments. The drying out of foreign inflows leads to real exchange rate adjustment. That can be managed through the use of foreign exchange reserves, but the adjustment has to take place. In that, there is a difference between countries with fixed and flexible exchange rate regimes.

If the developments so far are consulted, it is clear that countries with flexible exchange rate regimes have been able to depreciate their real exchange rates. Countries with fixed exchange rates have been less successful because the adjustment has to come via deflation. Though inflation is slowing down in most countries, there are only few which are already experiencing deflation. Also, given that inflation is slowing down fast in the euro area too, even relatively sharp disinflation is yet to lead to real exchange rate depreciation.

This process of adjustment has two consequences that are similar for all processes of the correction of external imbalances: whether exchange rate depreciates or prices fall, the costs of refinancing increase for the public and for the private sector alike. Devaluation increases the costs of services of debts in local currency while deflation increases costs relative to sales or incomes or public revenues, which all fall in any case in the current economic climate. In both cases, there can be widespread bankruptcies. In the case of countries with fixed exchange rates, there is the additional risk of abrupt exchange rate adjustment.

### **Constraints on policy responses**

This process of correcting for external imbalances constrains policy responses. On one hand, countercyclical fiscal policy and monetary policies may prove hard to implement. On the other hand, the banks may want to deleverage in view of rising risks of defaults on their investments. The latter process is not driven only by the recession in the NMS and FMS, but also by the recession in the EU as a whole and indeed by the global financial crisis. The former problem, of unavailability of expansionary monetary and fiscal policies, is

driven by limited options for local central banks and by rising country risks that limit the possibilities for public borrowing.

Thus, it is hard for these countries to deal with problems in the banking sector and governments' attempts to support growth are hampered by constraints on expansionary fiscal policy. Indeed, the policy that these countries are pressured to follow is pro-cyclical (quite the opposite of what is pursued in Western Europe, the US and Japan) which tends to deepen the recessionary tendencies rather than to spur growth. This does not necessarily lead to lower fiscal deficits and to a decrease of country risk on that account; quite to the contrary, fiscal deficits are increasing with declining public expenditures as government revenues fall and the costs of debt repayment rise. In addition, the incentive for banks to speed up the process of deleveraging increases. That, in turn, puts pressure on the exchange rates even further and increases the risks of one or another type of crisis erupting.

### **What can the EU do?**

Given this description of the macroeconomic situation, there are two things to do. One is to support struggling fiscal policies in these countries with the support to public spending. This is already being done by the IFIs, but much more will have to be done. This also makes sense in view of the need for all the countries to contribute to the increase of regional and global demand. Otherwise, these countries will only be able to revert to 'beggar-thy-neighbor' measures either through devaluations or through deflations.

In addition to that, there is the need to get the credit going. This means that support for the EU based banks will be needed. The situation in these banks is far from clear. There are indications that they are undercapitalized, some of them perhaps severely so. They are also looking at rising risks to their investments throughout the EU and beyond. At the moment, the classical run on the banks is not an immediate threat because deposits have been guaranteed by all the respective governments. Therefore, the issue is the need for new capital and for the support for their investments.

The natural way to deal with that would be for the affected governments to put aside money to invest in these banks; in addition, they could refinance their debtors, perhaps with some rescheduling of these debts. The idea would be for the various EU governments to recapitalize and refinance the balance sheets of the banks that face solvency and liquidity problems. Indirectly, they would be supporting the corporate and the household sector in the troubled countries. One can also envisage the support of newly set-up financing institutions to channel money to support infrastructure projects, support SMEs and labour market measures. The advantage of these is that their lending operations will not be hampered by the legacy of inherited balance sheet burdens.

## **The issue of sustainability**

Support for fiscal expansion has to satisfy the requirement of sustainability. In some EU and European countries, mostly not to be found among the NMS and FMS, sustainability is an issue due to high public debt to GDP ratios. This is also reflected in the decompression of spreads on sovereign bonds within and without the EU. Most of the NMS and FMS, however, have low public debt to GDP ratios and fiscal sustainability is not really an issue. The main problem, as argued here, are the external balances. Probably the extreme examples are the Baltic countries that have close to zero public debt to GDP ratios, but have rather less than favorable ratings for their sovereign bonds. Similarly, fiscal sustainability is not an issue in most Balkan countries, though they can hardly approach the private credit market.

There is a difference between the Balkan countries and Central European NMS. The former have high current account deficits driven by even higher trade deficits. The latter run current account deficits, but those are mostly driven by the deficits on the income account. In the case of the Balkan countries, real exchange rate adjustment will lead to lower imports, but the increase of exports will take some time in order to develop export capacity, in terms of volumes and in terms of diversity of the export structure. Therefore, real exchange rate adjustment should be more effective in Central Europe than in the Balkans, in Baltic countries, and in other countries further to the east.

This difference is important also in terms of sustainability. The fiscal risk is probably higher in countries with higher current account deficits and with lower export capacity. This is especially true for countries that rely on fixed exchange rates. In case of sharp adjustment in the exchange rate and the decline of consumption, mass bankruptcies may lead to fast increase in public obligations and the fiscal position may become unsustainable. For that reason also, it is necessary to support both the public and the private sector in these countries in order to keep the economy growing and preventing it to go into a deflation. A support package to allow a measured real devaluation in the form of coming off unsustainable fixed exchange rate regimes and support monetary stability at a new level will be necessary in such circumstances.

## **Growth strategy**

In the medium run, there is a difference between countries that can devalue and countries that will try to deflate the economy (for which there are limited possibilities in the current global climate of inflation rates close to zero). Recovery is stronger after devaluation, while deflation can drag on well past the medium run. This seems to be the lesson from the deflationary adjustments in some euro member states, e.g., Portugal. In the time of crisis, countries within the euro area are sheltered due to unacceptably high cost to leaving the euro. Their sovereign bonds are better rated and flow of credit suffers less. In the medium

run, however, return to higher growth rates tends to be more difficult. Similarly, countries with fixed exchange rates and with currency boards may have a difficult time returning to high growth in the medium run.

If that is true, the EU and the ECB, together with the IFIs, could support programs of fiscal expansion coupled with increased exchange rate flexibility. Clearly, one should aim at a floor to the exchange rate depreciation, which could be supported by the appropriate foreign reserve position and monetary policy. In that case, export led recovery and growth strategy seems the proper one for the Balkans and for the catching up process in general.

## **Conclusion**

There is room for the EU to support adjustment and recovery of countries that are constrained in their policy options due to high external imbalances. Banks could be set right and countercyclical fiscal policy could be supported. The EU and its member governments will have to rise to the challenge of a substantial and determined effort of policy coordination in this area to avoid a much deeper and prolonged economic crisis in both NMS and FMS with all the negative spillover effects that would have on re-establishing financial stability, the prospects for a recovery of the European economy as a whole and a possible unscrambling of some of the historic gains made in European integration.