EFFECTS OF THE GLOBAL CRISIS ON EASTERN EUROPEAN ECONOMIES

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Abstract. *Although sprang in the developed countries, the global economic crisis that mankind had recently crossed had some of the toughest effects all over the world. The rapid expansion was achieved amid the extremely high interconnect global financial systems, a fact that until recently was actually considered a positive thing that can help accelerate the development of the weakest economies and the overall well-being in the long term. Without totally contradict the above reasoning, this article is intended as a brief analysis and applied on East European states on vulnerabilities brought about by dependence on external financing given the conditions of a worldwide financial crisis.*

Keywords: *financial crisis; Eastern European Economies; external financing.*

JEL codes: E44, Q54, E43.

1. Introduction

Financial intermediation refers to allocating resources from entities that don't need them on a short run to those that are able to use them in a profitable manner. From this perspective financial intermediation should help economies to grow in a healthy way. However, practice showed that sometimes financial intermediation can have negative effects on economies. It's clear that on a long run a sustainable economy requires a stable financial system. Basically, financial intermediation is like a map of the economic relations established between different players that ensure the correct allocation of resources. If financial intermediation doesn't function well, the entire economy is affected.

Overtime, useful tools have been created to evaluate and ensure a stable financial intermediation system and in most countries this falls under the responsibility of central banks and other public institutions with a

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mandate in regulation and supervision of different financial sectors. An important factor in their success is their independence from other government institutions. To evaluate the stability of a particular financial system, one usually must look at its balance sheet for mismatches of maturities, currencies and geographical allocation between the corresponding assets and liabilities. For example, if a bank borrows money in short term and lends money on a long term, it expose itself to the risk of not finding short term financing over and over again at low costs.

In most of the eastern European countries however, the main vulnerability of financial systems rely on mismatches in geographical allocation. Before the crisis, eastern EU banks borrowed money from external sector, usually from other nonresident group entities, and lent money to residents. This meant that financial intermediation was going only one way into the countries and soon eastern EU countries became dependent of external financing. The financial crisis affected in the first place the most developed countries of the world, but soon the eastern European countries became to experience problems of their own due to a sharp drop in external financing. This phenomenon has multiple causes and many different negative effects that will be further analyzed within this paper.

This article is divided in four parts. After the introduction, the second part is dedicated to a brief analysis on the financial systems in the eastern European countries before the beginning of the financial crisis. The major causes of its dependency of external financing will also be analyzed, among which the monetary policies implemented by central banks and their very weak financial systems before joining EU. The third part is dedicated to the negative effects of the financial crisis that were caused by the sharp cutting of external financing that these countries experienced and the successfulness of economic policies that were adopted to counteract these effects. Chapter four is dedicated to conclusions.

2. The eastern European financial systems before the crisis

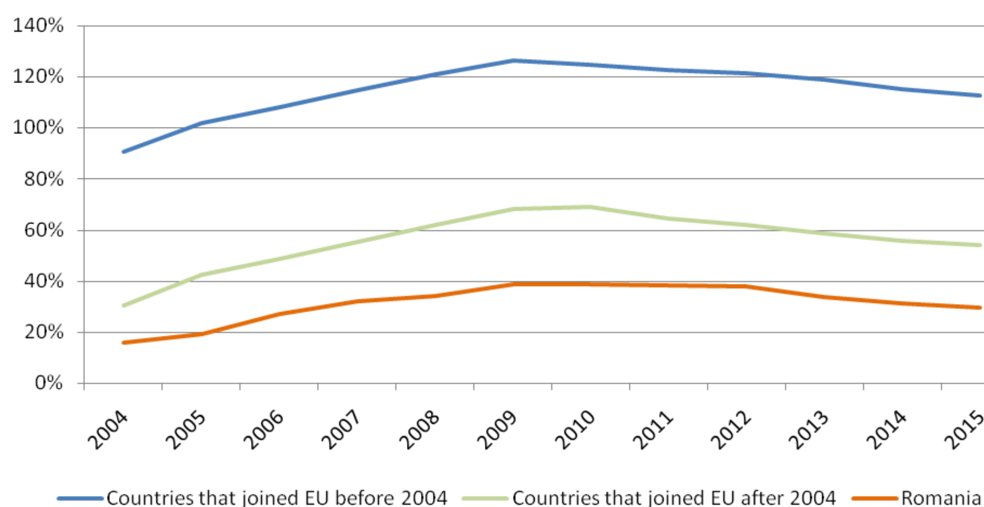
The most important European Union enlargement process happened in 2004-2007 when 12 countries, mainly from Eastern Europe, joined the EU. This happened just before the beginning of the greatest global financial crisis that the world has seen since the Great Depression of 1929.

Some of these countries still had economic problems of their own, the decision of allowing them to join EU later proved, at least in some degree, to be one of a political nature.

As the European Union forms a common market, one of the key conditions for every country that aspires to it is the so called "liberalization" of the capital and financial accounts. This basically means to allow all foreign investment inflows and outflows of capital with no restrictions, including financing of financial intermediaries.

Also, in the developed countries, around this same period, a significant financial bubble was forming and financial intermediaries had plenty of liquidity for which they would literally hunt for ways to place it, with slightly higher yields. As in their resident countries interest rates were very low due in some extent to the fact that loans were considered almost always "risk free" and interest in the eastern Europe countries were significantly higher as some, if not all of these countries, were still battling with inflation, financial intermediaries started to flood with liquidities these newly opened economies. This lead very quickly to a sharp increase in consumption and in the accumulation of current account deficits that prove to be unsustainable, once the crisis started.

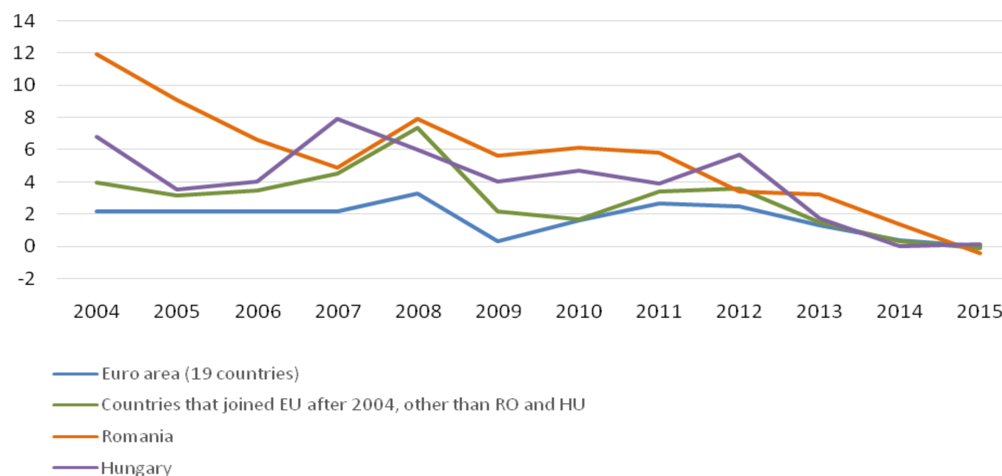
It's clear that at least for some countries that this happened, among others, due to a very poorly developed financial system prior to joining EU. Chart 1, bellow, shows the large differences between the degree of access of the real sector (households, nonfinancial companies and nonfinancial organizations serving households) to banking finance. On average, at the end of the year 2004, the twelve countries that were candidates to EU had a total stock of liabilities to resident banking sector of about 30%, as percentage of their corresponding GDP; Romania recorded a significantly lower level of about 16%, while the other countries that were at that time part of EU (most of them being part of Euro Area also) held about 91%. This indicator can be viewed as the degree of indebtedness of the real sector of an economy. Consequently, potential was there for foreign banks to invest in Eastern Europe. These indicators evolved in a similar way for all the analyzed group of countries (before the crisis the financial system expanded and in the years after, the system got back to previous levels of intermediation).



Source: ECB, Eurostat.

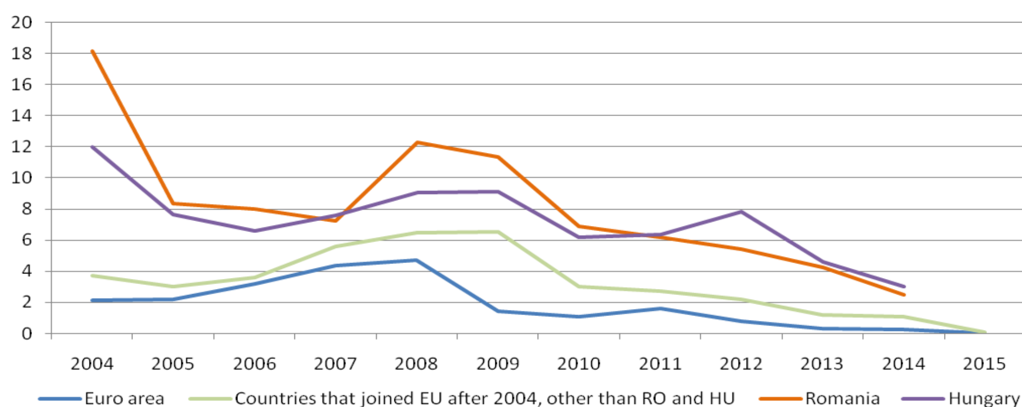
Another reason, due to which this phenomenon happened, is the different monetary policies that were implemented in some Eastern Europe countries. Especially countries like Romania and Hungary were still struggling very much with inflation during that period. Chart 2 shows that in 2004, Romania recorded an inflation of about 9.1% (as published by Eurostat, using HICP), a level significantly higher as compared with Hungary (6.8%), and the other 10 countries that were candidates to EU (3.2%) and also as compared to Euro Area level (2.2%). Inflation determined central bankers to keep interest rates at levels significantly higher that of other EU countries. This can easily be seen in Chart 3. Together with the “liberalization” of the capital and financial account, this situation determined foreign banks to lend money in foreign currency to their subsidiaries in Eastern Europe in order for them to be able to borrow their resident economies. As interest rates in foreign currencies were significantly lower, clients could borrow more from banks in such conditions and banks were also happy that they could transfer the foreign currency exposure to their customers. This created additional problems in terms of macro financial stability, revealed later by the crisis.

Chart 2: HICP annual change, %



Source: Eurostat.

Chart 3: Money market interest rates - 6M



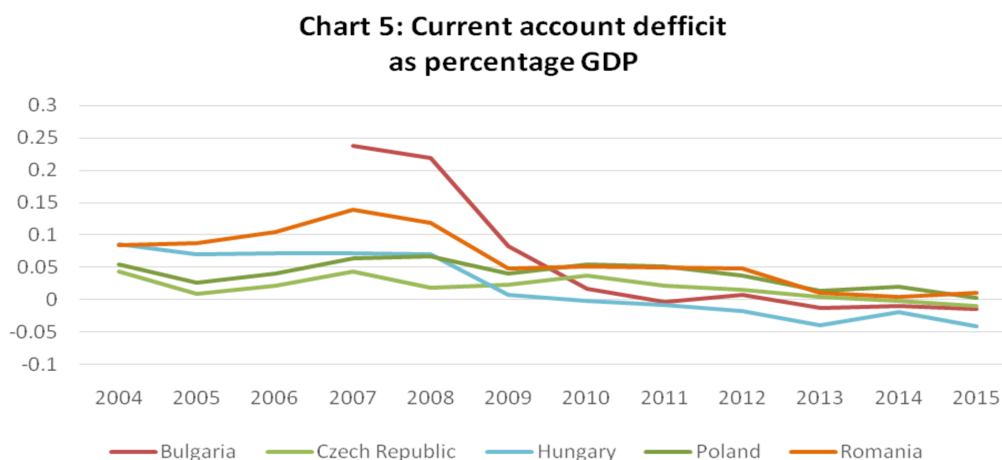
Source: Eurostat.

It's important to mention that financial intermediation wasn't the only channel through which the external sector fueled consumption and the high GDP growth rates recorded in eastern EU countries before the financial crisis. Important amounts of external financing were recorded in the form of direct investment to the real sector and, to a lower extent, in the form of portfolio investment. Direct investment also help created a dependency for the external sector, but with much lower negative effects due to the fact that it help to create jobs and to increase the overall development level of

countries. However, these also stopped or significantly lowered after the beginning of the financial crisis, for example in Romania inward direct investments drop from almost 9 billion EUR in 2008 to about 3 billion EUR in 2009. All in all, the long term relation involved by direct investment meant that these investments were not withdrawn by investors after the financial crisis, but merely the inward flows were limited. This was not the case for financial intermediary's investment that was withdrawn rather quickly, starting with the financial crisis.

3. Effects of the financial crisis throughout Eastern Europe

The global financial crisis proves to be a big challenge for most of the Eastern Europe countries, in terms of combating its negative effects by the authorities responsible with macroeconomic policies. It's obvious that in most of these countries the main problem was the strong dependency of external finance in the form of private flows of investment (including financial loans/deposits of foreign banks in local subsidiaries).



Source: Eurostat.

This phenomenon can be most easily seen in the percentage of current account deficit in GDP (chart 5). The financial crisis that began in 2008 triggered a sharp drop in external financing and as a result in a sudden adjustment of current account deficit. Romania recorded in 2007 the peak of 13.8%, in 2008 11.8% and after the crisis started to make its effects felt, in 2009, Romania recorded a current account deficit of about 4.9%. This

came together with a strong depreciation of national currency versus EUR and USD which can be translated as the action of the markets to balance the situation of foreign currency exits from these countries. It helped exporters to make their products more competitive, it decrease the level of imports in order to limit the pressure on the current account, but it also made it very hard for individuals (households) to repay their loans denominated in foreign currency.

This situation created a huge pressure on local banks. On one hand, their own parent banks were starting to withdraw their investment as liquidity were scarce throughout the whole world, and on the other hand the debtors started to have problems in observing their debt schedule.

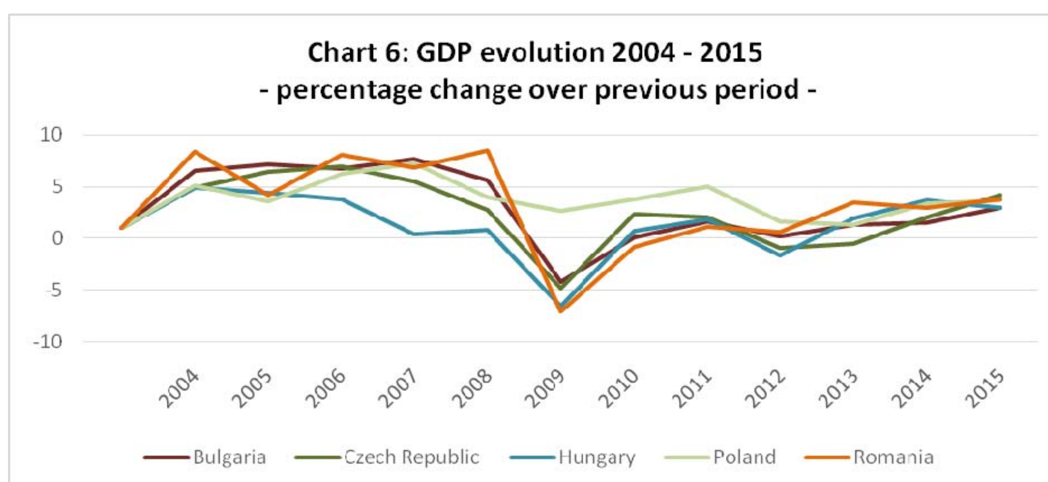
There were not too many options for the monetary authorities to stop or limit this newly created situation. Lowering interest rates was one of the first measures taken when the financial crisis broke. With the pressure on the national currency and the high degree of imports in the general consumption, economies were no longer confronting with a risk of inflation, at least in the short run. As prices stability was no longer a major problem, most central bankers from Eastern Europe moved their attention on financial stability. The general way in which a central bank can help its financial system during a crisis is to ensure sufficient liquidity. However, as we are talking of financial crisis, there is never sufficient liquidity. One of the more inspired measures before the financial crisis was maintaining of a high level of minimum reserve requirements for foreign currency liabilities. This meant that each time a parent bank made a deposit in a local subsidiary; this subsidiary was required to place a percentage to the central bank and could only use the remaining amount to borrow locally.

Freeing these reserves was a real solution to the liquidities needs, however it created additional problems. First of all, during that time it wasn't clear for anyone whether these reserves are sufficient to meet the increasing deleveraging and secondly, freeing the minimum reserves requirements meant a decrease in the international reserve, which is never well seen by foreign investors, especially in times of crisis. A vicious circle was then created.

Nevertheless, the situation was worsen by the fact that governments responsible for fiscal policies had problems of their own in terms of meeting their commitments, in some cases even concerning payments of salaries and social pensions. In Eastern Europe not only there was no money to help financial stability, as in other more developed countries, but in fact governments needed financing themselves. This happened mostly

due to the fact that prior to the financial crisis, buget deficits were recorded despite the significant GDP growth year after year. This means that governments were to some extent also dependent to external financing which stopped suddenly. Unfortunately, from this perspective, most of the fiscal policies implemented in EU were of a pro-cyclical nature, as Maastricht criteria were often broken.

Chart 6, bellow, shows the GDP evolution in the Eastern Europe countries. The effects of the financial crisis can easily be seen in the sharp drop recorded in 2009 by all of the analyzed countries, although not with the same force.



Source: Eurostat.

With all these problems, the only solutions to the financial crisis were found by authorities in the form of negotiation with important international organizations in order to limit these effects. Important to mention are the IMF official agreements programs and the Vienna agreements from the period 2009-2010. The IMF financing allowed central banks to consolidate their international reserves and to free the minimum reserve requirements for commercial banks, while also give investors a guarantee that their money are safe in these countries. Vienna agreement also helped financial intermediaries by easing the pressure on their liquidities, which in term helped fiscal authorities to access important financial resources by borrowing from these banks. These measures work to some extent as most of the economies overcome the crisis and generally recovered. However, the economic model after the financial crisis is certainly different from that

of before. Current account deficits are no longer over 10% of GDP and foreign owned banks don't rely only on external financing, but also from savings of local populations. Consumption recovered slowly, as export increased constantly and allowed foreign currencies to enter in economies. Nonperforming loans, a product of financial crisis, recently started to diminish, although they are far from the US levels for example. Also, the banking sector started to record profits. However, the cost for this adjustment was quite high for everyone.

4. Conclusions

Financial intermediation is at the heart of any economic model and its analysis is of the upmost importance. Although the data on vulnerabilities in the Eastern Europe economies were available for anyone interest in them, it seems that the financial crisis took everyone by surprise. This paper underlines that most of the mistakes related with macroeconomic policies were made by authorities before the financial crisis. All ex-communist countries wanted to join the European Union as quickly as possible and for good reasons, like the free circulation of individuals and the free market that promised to help a quick development.

However, joining EU not fully prepared, combined with the financial bubble that was forming in the western countries, proved to be costly on a long run for some countries. The liberalization of the capital and financial accounts in certain conditions lead to the creation of a strong dependency of external financing, which was always seen as a main vulnerability for the financial sector. Probably we all hoped that this will remain only a potential risk that would never materialize, but this was not the case.

The exuberance of finally manage to join EU, after the efforts made for more than a decade lead to poor decisions afterwards. The story of developing the financial crisis in Eastern Europe give us important lessons of how important the simple analysis of sectoral balance sheets can be and how fast things can get ugly if important aspects are ignored.

As in the west, the financial crisis revealed imbalances and adjusted them rapidly to levels of more common sense. It's unfortunately that this process was so costly for many countries in terms of unemployment, foreclosures and a general reduction in life quality.

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