Deepening economic crisis in Eastern Europe

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Recent reports indicate that the economies of many central and eastern European states are headed for new shocks. Despite attempts to conjure up optimism over the prospects for these countries, institutions such as the European Bank for Reconstruction and Development (EBRD) and the International Monetary Fund (IMF) are warning of the danger of further economic decline in the region, which would have serious consequences for Europe as a whole.

"The consequences of the world economic crisis will burden this region more than the rest of the world in coming years," declared the chief economist of the EBRD, Erik Berglöf, speaking on the fringes of a conference held by the Austrian Central Bank in Vienna last week.

In its Transition Report, issued at the beginning of November, the EBRD examined the reasons why central and eastern Europe had been hit particularly hard by the crisis. One of the main problems identified by the ERBD was the manner in which economies in the region had been financed in those years when they experienced sustained growth.

This growth was made possible almost entirely by foreign direct investment. As a result, many national economies in eastern Europe collapsed when foreign investment suddenly stopped following the eruption of the global financial crisis. The EBRD expects that in the coming months the current outflow of capital from the east back to western banks will continue.

The ERBD expressed concern over the extent to which eastern European economies were dependent on foreign currency loans. In many countries, loans are made only in euros, dollars or Swiss francs. In Austria, generally grouped among the western European economies, foreign currency loans total 17 percent of gross domestic product. The corresponding percentage in Latvia is 90 percent; in Estonia, 80 percent; and in Bulgaria, 50 percent of GDP.

For broad layers of the population, foreign currency credits have become a huge debt trap. The indebtedness of private households has risen rapidly. In the Baltic states, it amounts to nearly 100 percent of GDP. This compares to an average of 50 percent for western European states.

This tendency has been encouraged by the banks. Ordinary citizens were led to believe that they could avoid the high interest rates linked to their national currency by taking out loans in other currencies. However, financial institutions in the region were themselves burdened with foreign loans and sought to pass on the risk to their customers.

The ERBD now declares that eastern Europe must shed its "dependence on foreign currencies," although it played a major role in promoting just such a policy. The ERBD was created in 1991 precisely to accelerate investment projects in central and eastern Europe. The bank remains the single biggest investor in the region and was responsible for drawing up the investment concepts that contributed to the 2008-2009 economic crash.

The International Monetary Fund has also issued a number of blunt warnings about developments in eastern Europe. The Austrian *Standard* quotes IMF economist Christoph Rosenberg, who declares that the recent recovery of financial markets in the region is almost exclusively due to the increased appetite for risk on the part of investors and has little to do with any improvements in the real economy. Rosenberg warns of a new stock market bubble, which will have dire consequences when it collapses.

Rosenberg was not prepared to commit himself when asked if conditions would improve for eastern European markets. "We can only do what we did prior to the economic crisis—warn of the dangers," he said.

However, when one examines the state of economic conditions, one can only conclude that it is already too late for warnings. The situation is most dire in the Baltic states. In Latvia, bankers are speaking of a "dramatic development." Despite draconian austerity measures by the government, the country is moving ever closer to bankruptcy.

The rates for credit default swaps, which reflect the perceived risk of state bankruptcy, currently lie between 500 and 600 points for the Baltic states. In comparison, the rate for credit default swaps for Austria is around 60 points.

Western European banks, which invested heavily in the region in the boom years that preceded the financial crash, are reacting with increasing nervousness. "Patience is coming to an end," Swedish Finance Minister Anders Borg said recently. He threatened to block previously agreed new lines of credit to eastern states. Sweden is taking a particularly hard line in insisting that debtor states increase their savings. The two largest banks active in the Baltic region are the Swedish banks Swedbank and SEB.

Due to the close economic ties between economies in the region, the crisis in Riga is having a knock-on effect. CDS rates for the neighboring countries of Estonia and Lithuania have climbed significantly in recent weeks.

It is not only the Baltic countries that are facing serious difficulties. The crisis is also deepening in southeastern Europe. A number of reports have pointed out that the full impact of the economic crisis has been delayed in Romania and Bulgaria, and it is assumed that 2010 will be a very turbulent year in both countries.

The ongoing crisis has delayed prospects for the introduction of the euro as the common currency in the eastern European member states of the European Union. Only the two smallest countries in the region, Slovenia and Slovakia, have thus far introduced the euro. Eight other east European EU member states still retain their national currencies.

The German business newspaper *Handelsblatt* noted that the current economic crisis has "once again increased the economic gulf between east and west, which will in turn delay the process of euro-conversion for years." The newspaper continued: "Recently, both the EU commissioner for currency, Joaquín Almunia, and Gertrude Tumpel Gugerell, a member of the presiding board of Eurozone countries, warned of overly hasty moves to introduce the euro."

The banks, big business interests and governments are united in their conviction that the burden of the crisis must under all circumstances be borne by the general population. All the governments in eastern Europe have slashed budgets and introduced cost-cutting measures in response to pressure from the IMF, the European Union and western European banks.

In Latvia, this has already led to a social disaster. The government has decided to close half of the hospitals in the country by the end of the year, which means there will no longer be any guarantee of medical care for broad layers of the population. As the social and medical infrastructure collapses, virulent diseases such as the H1N1 virus are spreading rapidly. For the first time last week, the authorities referred to the outbreak of an epidemic in the country.

More and more citizens are experiencing a sharp decline in their living conditions as a consequence of government attacks. A report in the *Standard* recently related the case of a Latvian school rector. Because his salary was cut by around 60 percent, he is now forced to work after school hours as a night watchman to provide for his family.

Such conditions will inevitably lead to intensified conflicts between the working population and the political elite. Protests and demonstrations broke out against government policies at the start of the year in Latvia.

Twenty years after the collapse of the Stalinist regimes, there is growing popular sentiment in eastern Europe that the introduction of capitalism, notwithstanding hatred for the repressive Stalinist governments, represented a disastrously regressive step.