The Last Shall Be the First: The East European Financial Crisis

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In the fall of 2008, Central and Eastern Europe became a flashpoint in the global financial crisis. The region was in a state of severe overheating in all regards. Inflation surged everywhere and to double digits in Bulgaria, Estonia, Latvia, and Lithuania. Wages and real estate prices skyrocketed, rendering these countries ever less competitive, which further undermined their current account balance. Output plunged and unemployment soared. The country with the greatest overexpansion, Latvia, was feeling a credit crunch already in 2007, as its banks seemed overstretched with excessive lending, and the risk of a fall in real estate prices with ensuing credit losses was evident. The big blow was the Lehman Brothers bankruptcy on September 15, 2008. All of a sudden, world liquidity dried up, and vulnerable Eastern Europe was left with no credit.

However, in less than two years, by March 2010, the crisis in that region had more or less abated. Public attention moved from Latvia—the country that suffered the most pain in the East European crisis—to the PIGS (Portugal, Italy, Greece, and Spain), in particular to Greece. The issue was no longer why Latvia must devalue but what Greece could learn from Latvia.

The East European financial crisis was a standard credit boom-and-bust cycle leading to a current account crisis. What lessons can be drawn from it for Southern Europe and the rest of the European Union? What happened during the East European financial crisis, and how was it resolved so quickly? Senior Fellow Anders Åslund brings home the lessons from this episode before it fades from public memory, because nothing is more easily taken for granted than success. Crisis resolution in these countries was decisive and successful, and the entire region is likely to return to economic growth by the second half of 2010.

Countries in Focus

Åslund focuses on the ten new eastern members of the European Union: Estonia, Latvia, Lithuania (the three Baltic countries), Poland, the Czech Republic, Slovakia, Hungary, Slovenia (the five Central European countries), Romania, and Bulgaria (Southeastern Europe). Bulgaria and Romania acceded to the European Union in January 2007. The other eight joined in May 2004.

Slovenia and Slovakia adopted the euro in 2007 and 2009, respectively. Estonia, which has a fixed exchange rate, will adopt the euro in January 2011. Latvia, Lithuania, and Bulgaria have fixed exchange rates based on currency boards, and Poland, the Czech Republic, Hungary, and Romania have floating exchange rates and essentially pursue inflation targeting.

One of the greatest outcomes of the East European crisis is that the worst hit countries—Latvia, Lithuania, and Estonia—were not forced to devalue contrary to claims of a broad chorus of economists. Instead, the three Baltic countries pursued what they called “internal devaluation.” Their governments cut public wages by up to 35 percent, and the private sector followed suit. They slashed public expenditures, and their cost levels became competitive, allowing them to turn their large current account deficits swiftly to substantial surpluses. Both inflation targeting and pegs remain viable exchange rate policies, and internal devaluation is likely to become the rule for eurozone countries in financial hardship.

Equally laudable was the political economy of this crisis. Instead of widely predicted social unrest, the East European public has accepted their considerable hardship with minimal protests. Åslund argues that multiple factors contributed to social peace. Large majorities favored wage cuts over devaluation as the lesser evil, because the benefits of devaluations would mainly accrue to wealthy exporters. After many years of high economic growth, people were prepared for some suffering. These states had recently become free and were prepared to stand up for their nations, and they were all used to crisis from the postcommunist transition.

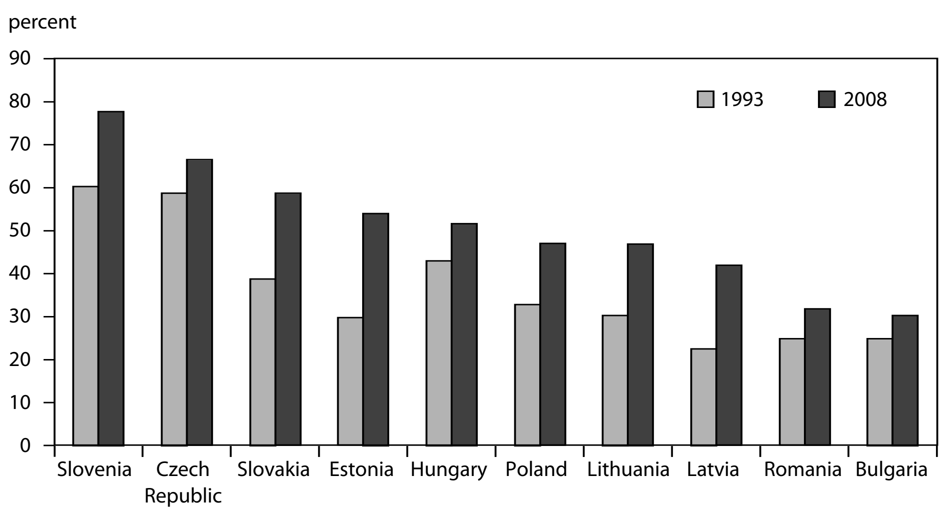
Åslund finds that a new European fiscal retrenchment is being carried out on the basis of a new political economy of pragmatism and fiscal conservatism. The center-right has never been stronger in Eastern Europe. One of the lessons from the East European crisis is that it is politically possible to cut public expenditures, salaries, and employment, as well as rationalize health care and education. The big remaining task is pension reform.

On the international stage, the International Monetary Fund (IMF) stands out as the great victor. It revived the old Washington Consensus of a few rudimentary financial conditions, such as tenable exchange rate policy and reasonable fiscal and monetary policy, but it allowed the well-governed countries larger public deficits during the crisis and offered much more financing, also for budgets, than before with the understanding that this was a temporary current account crisis. It acted faster than usual. The European Commission entered into an astonishingly successful partnership with the IMF in Eastern Europe. It allowed the IMF to take the lead, while providing substantial financing, more than the IMF in the case of Latvia, and checked the work of the IMF. When financial crisis hit the eurozone, however, the European Union seemed to have forgotten all its fortuitous lessons from Eastern Europe, attempting to keep the IMF out. In the end, the European Union let the IMF take the lead also within the eurozone, which helped mitigate the crisis.

The European Central Bank (ECB), on the other hand, has been a great disappointment in the East European financial crisis, according to Åslund. Its single contribution was to expand its credit supply to salvage the European banking system in the fall of 2008, also saving their subsidiaries in Eastern Europe. But before the crisis the ECB ignored financial stability and the massive overheating in some EU members both inside and outside the euro area. The entry conditions to the eurozone demand that a country peg its exchange rate to the euro for at least two years, but the ECB did nothing to stabilize the economies of these euro candidate countries. It could have offered swap credits to eastern EU economies outside the euro area, but it did not. Evidently, the ECB needs to reconsider its policies, especially outside the eurozone, and become more proactive.

In the end, Eastern Europe had a "good crisis," which is likely to benefit both Eastern and Western Europe and thus the European Union. Western Europe will have to learn from Eastern Europe, erasing the current division between first- and second-class members within the European Union. The East European countries have persistently had much higher growth rates than the West European countries, and economic convergence between them in terms of GDP per capita has been impressive for the last nearly two decades (see figure 1). Thanks to the East Europeans, the West Europeans have slashed their corporate profit tax rates and have also been enticed to liberalize their labor markets. Now, they will also learn fiscal policy from the east. Rather than being the laggards, the East Europeans will be the leaders in economic policymaking.

Figure 1 GDP per capita in the ten Central and East European countries as a share of average EU-15 GDP per capita



PPP = purchasing power parity

Note: GDP per capita in PPP (constant 2005 international dollars) as a share of average EU-15 GDP per capita in PPP.

Source: World Bank, *World Development Indicators* online database (accessed on August 9, 2010).

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