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**Twenty years after the collapse of “communism”, the global financial crisis pushes some emerging European economies to the brink of collapse!**



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Emerging economies are now so closely integrated with developed ones that financial stress transmits rapidly and forcefully to all major emerging regions and multiplied through all parts of the financial sector: The global financial crisis, which pushed some emerging European economies to the brink of collapse, revealed risky imbalances two decades after “communism” (planned economic model) fell.

**The global financial and economic crisis has literally hit home in many parts of emerging Europe. What started as a financial crisis has become a social and human crisis. The global crisis has come on the heels of the food and fuel crises, which had already weakened people in the region by reducing their purchasing power. Today, rising poverty and joblessness are pushing households into poverty and making things even harder for those already poor.**

The Central & Eastern European nations that joined the European Union, along with the southern Balkans, were driven into recession by the worldwide credit squeeze and lost investment. Commodity-rich nations including Russia and Kazakhstan were punished for failing to diversify away from energy reliance. Subsequently, emerging European nations are struggling to escape the deepest recession since they adopted free-market policies.

**Eastern Europe was the worst affected of all emerging markets by the worldwide financial turmoil because the high level of financial integration they have reached with major economies has aggravated the impact. Bank lending linkages appear to have been the main driver of stress transmission.**

Western European banks have dominated bank lending flows to emerging economies since the mid-1990s. By end-2008, their assets in emerging economies exceeded 10% of developed-economy GDP, compared to a combined 2.5% of GDP for Canadian, Japanese, and U.S. banks.

Emerging Europe stands out as the main recipient of bank lending flows. Foreign claims in terms of destination GDP are the highest among emerging regions. The intensity of these links helps explain why the global financial crisis, which is mostly centered on banks, had a virulent impact on various emerging European countries.

The effort to raise living standards to Western levels encouraged a credit boom, excess borrowing and a shift towards indebtedness in foreign currencies. The International Monetary Fund needed to step in and finance rescue programs in Hungary, Latvia and Romania as the countries faced defaults and they struggled to refinance maturing debt and loans, many denominated in foreign currencies. The IMF has provided about \$65 billion of loans to Eastern Europe, which required more than \$100 billion in bailout money.

As the recession deepened and unemployment soared, non-performing loans increased across the region as borrowers found it harder to make repayments. Declining currencies also pushed up the costs of loans taken out in Euros or Swiss Francs before the crisis to benefit from lower interest rates.

**The crisis has shown the need for urgent steps to help reduce dependency on foreign-exchange lending and to manage more effectively the demand for credit. Attempting to reverse financial integration would be the wrong**



**conclusion to draw from the crisis.** The presence of foreign banks and the resultant depth of financial systems played a crucial stabilizing role.

Natural resource-rich countries, such as Russia, Kazakhstan, Azerbaijan and Turkmenistan find conducting economic policy difficult as revenue and foreign-currency inflows fluctuate along with the global markets for commodities. The lack of alternative sources of income presents a threat to their economies. The long-term goal of economic diversification remains elusive. Dependence on wealth from such resources and the very lack of diversification itself stands in the way of development of the sort of institutional framework that would support the creation of a more diverse industrial base.

Russia's stock market has fallen so rapidly that trading has been suspended several times; the country has been forced to use 1/3 of its foreign exchange reserves; Ruble has quickly lost value; with global prices of its major export commodities fallen sharply and like in other emerging European economies investors quickly pulled foreign capital out and into perceived safer investments ("flight to quality").

**There is the necessity to diversify Europe's emerging economies, to not so much be reliant on the exports of oil and gas and metals. There is also the need to avoid just being dependent on very few production lines, which in a difficult situation has an immense impact on the overall economy.**

The crisis also meant a setback for efforts to further overhaul eastern European economies that would enable them to better compete with other emerging markets. Euro-aspirants are forced to delay the changeover as the recession cut tax receipts, spending increased on bank bailouts and unemployment benefits and currencies have become more volatile.

Estonia, which seeks to start using the euro in 2011, is struggling to stay within the EU deficit threshold this year to qualify. Poland's ballooning deficit and rising state debt forced the country to abandon plans for adoption in 2012.

**The rush to euro adoption, especially in the Baltic states of Estonia, Lithuania and Latvia, which have the EU's worst recession, helped exacerbate the effect of the crisis because expectations of entering the euro boosted foreign currency-denominated loans. Countries that have delayed euro-entry decisions, such as the Czech Republic, have fared better.**

It is clear that the transition has slowed down, but has not stopped. Pytheas expects the region's economies to grow about 2.5 percent next year after contracting an average 6.3 percent this year. The recovery, however, will be curtailed by continued tight lending conditions by western lenders.

Bulgaria, Latvia and Lithuania, which have fixed exchange rates, will contract further as they cut wages, prices and government spending. Albania, Poland, Slovakia and Slovenia will grow faster next year than their neighbors due to relatively unharmed banking systems. Recovery prospects in Russia and Kazakhstan though, depend on the ability of the authorities to clean up their financial industries – **to clean up the banking sector so that banks can provide a lifeline for firms and businesses to grow and create jobs, improve the business climate to attract private capital flows, make public spending more efficient so that the benefits reach**



**working families, and continue to finance key public investments in infrastructure.**

It is clear that the shock to financial systems in advanced and emerging economies is too large to be dealt with on an individual basis. **Strengthening current account and fiscal balances can help emerging economies during periods of global financial calm. However, during a major global financial shock reducing country vulnerabilities alone cannot insulate emerging economies from the transmission of stress.**

Instead, a coordinated policy response by developed and emerging economies is required to prevent further escalation and spreading of financial stress. Such a response needs to involve many elements, primarily though, (a) access to external funding for emerging economies and (b) more efficient coordination between home and host country financial supervisors.

**While achieving financial stability should be the immediate goal, policymakers ultimately need to work toward strengthening multilateral insurance systems: this would allow emerging economies to reap the benefits of international integration while limiting the potential risks from greater external financial integration.**

Government spending should be made more efficient. Social spending makes up more than half of government expenditures so governments will need to make education, health care and social security more efficient. School systems need to be resized to fit shrinking enrollment numbers due to falling fertility. Health care has to be restructured because many countries now have the health problems of high-income countries with the fiscal resources of middle-income economies. And social security has to be restructured to recognize that many countries in the region have aged before they have become wealthy. Reforms will help make governments fiscally healthy, economies robust, and societies more fair.

Finally, emerging economies are expected to play a larger role than ever before in the global recovery from the financial crisis. By end-2009, emerging economies are expected to constitute the vast majority of global economic growth due to negative growth in many developed countries. Recovery of the emerging economies will be essential to global growth, as China, Russia, India, Brazil and other large emerging economies now make up 30% of global GDP.



The transmission of the crisis from the USA and Europe to the rest of the world came through a number of channels:

1. The withdrawal of funds by some of the major financial institutions from their subsidiaries located in the emerging economies. The general contraction of the balance sheets of the major institutions and the need to rebuild their capital base has constrained the funding available to other institutions in both the industrial countries (e.g., hedge funds) and in the emerging world that rely on dollar (or even Euro) funding. This has been the case notwithstanding the massive support injected into banking systems in the financial centers that are home to most of the major international banks.
2. The seizing-up of the international credit markets. Credit flows through the international banks and global bond markets to emerging market countries all but dried up. This has created significant financial stress in some of those countries – especially those in Central and Eastern Europe – that ran up dangerously large current account deficits and took on substantial international debt. For example, BIS data show that consolidated claims of BIS-reporting banks on all emerging market economies decreased from a peak of \$5.4 trillion in June, 2008 to \$4.6 trillion by December – a decline of over 14%. No emerging market regions were spared, and all of them saw similar declines. Recent anecdotal evidence suggests that this withdrawal has continued in most regions. Data on capital flows show an even more dramatic picture. Net private flows to emerging market countries peaked at about 5 percent of GDP in 2007. However, all categories of inward flows to emerging market countries have registered significant declines from 2007 to 2008 and are projected to decline further in 2009. The cumulative decline in the major categories of flows to emerging market countries between 2007 and 2009 are currently expected to be very large: 62% for international bond issues; 61% for commercial bank loans; and 54% for inward direct investment. The flow of export credits to the emerging market countries as well as inward portfolio investment all but collapsed in 2008. The withdrawal of portfolio investment was a key factor behind a decline in emerging stock markets that exceeded the sharp declines in advanced economy markets.
3. The impact of the crisis on economic activity - in the first instance, in the United States and Europe, and subsequently in Japan. Initially, this manifested itself in a sharp contraction in exports from those emerging market countries that had become the largest exporters to the industrial world. Quite rapidly, however, exports declined from the other emerging economies, i.e., those whose exports consisted of raw and intermediate goods shipped to those larger emerging market countries, particularly China that had become key providers of final manufactured goods in the increasingly complex supply chains that came to populate world trade. This fall in exports – at a virtually unprecedented rate of collapse - created an internal feedback loop wherein the initial reduction in trade weakened the domestic economies of the emerging market countries, with further negative feedback on the financial sectors in those countries as the quality of domestic credit deteriorated.



4. The uncertain prospects for remittances – an important source of income and foreign exchange in many emerging market economies. Total remittances to emerging market countries were over US\$ 206 billion in 2007 and are estimated to have reached more than \$230 billion in 2008. Like unemployment figures, remittances tend to lag the decline in economic activity – and will likely lag in the recovery. While recent data are sketchy, remittances to emerging market countries appear to be falling significantly and are estimated to total only about \$170 billion this year before recovering somewhat to about \$195 billion in 2010. Such projections are subject to a wide margin of error and are dependent on an assumed recovery in the global economy. Interestingly, the transfer of domestic remittances, i.e., those remittances that go from individuals who have moved to urban areas in search of employment and higher income to those left behind in the rural or less developed regions of a country, have also declined. This is helping to transfer the weakness in the export and service sectors in emerging economies to parts of those countries that otherwise would have been less affected. The return of workers from abroad could put additional pressure on these regions as those workers seek employment in already depressed economies.
5. Finally, the psychological factor. The world has become all too familiar with financial crises. But a financial crisis originating in the USA and spreading quickly to other industrial countries took most of the world by surprise. So did the severe worsening of the crisis in September and October, 2008 which saw the collapse of some of the world's most prized private financial institutions and extraordinary – and untested – policy actions by industrial country governments. This was quickly followed by a seizing-up of financial markets around the world, a massive loss in asset values, and a virtually unprecedented collapse of exports. The decline in asset values, especially of equities and houses, and the rapid rise in unemployment brought that insecurity and its accompanying fear to consumers. Financial systems and economies are driven by confidence. These events thoroughly shook consumers' confidence, causing a self-aggravating feedback to the rest of the economy. This experience may well affect the nature of any recovery in ways as yet not fully understood.

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