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IMPACTS OF THE GLOBAL CRISIS: SPECIAL FOCUS ON CENTRAL EUROPE AND HUNGARY

The Central and Eastern European countries outside the Euro area were hit particularly hard by the global credit crunch; their previously fast growth was replaced by a recession, putting their catch-up as part of the integration process into a completely different context. The crisis has made it clear for some of the Central and Eastern European newcomers that growth cannot be maintained based on generous inflows of capital. The abundant international liquidity that marked the years before the crisis vanished, FDI in the region plunged dramatically, and the drying-up of the government bond market imposed extremely tough limits on the external funding of budgetary overspending. The crisis hit Hungary especially hard as this country was already at a low growth path after the 2006 stabilisation package.
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Losing ground for quite some time, this international financial and economic crisis proved to be a major challenge both for the European Union as a whole and its Member States in the global reshuffling of power that was triggered by processes of globalisation. Enlarged from 15 to 27 members in the last two rounds, the integration organisation is already being severely tested without the global crisis thanks to its ageing society, its disappointing innovation performance, poor competition, heavy indebtedness and its clumsy decision-making procedures.

With the accession of the new Member States, the EU has expanded its geographical borders, increased its population and boosted its production and market potential, thus making an attempt to slow down and stop its marginalisation in the world economy and the international political arena. The horizontal enlargement, however, led to greater development differences within the Community. Compared with any previous enlargement, the EU is faced with far more complex tasks of helping its Members catch up, deepening integration and strengthening cohesion, as they require a root-and-branch reform of the EU's institutional background, operational, decision-making and interest-asserting mechanisms.

EU institutions failed to give instant crisis management responses to the crisis that deepened quickly from September 2008 on, and so pushed by their own national

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interests, Member States started to save their banking systems, strategic sectors and jobs on their own. Later on, in an attempt to handle and weather the consequences of the crisis in the long run, the European Commission elaborated its European Economic Recovery Programme, the key elements of which cover all these sensitive areas. The crisis showed how weak and unprepared the European Union was as regards crisis management, both in terms of its institutions and Community resources. This increasingly raises the notion that the EU's development has come to a turning point. The EU urgently has to prove whether it is able to offer efficient Community responses to the crisis on the basis of the cohesion built up so far, and in the meantime, to keep pushing ahead consistently with completing the launched reforms and give fresh impetus to the Lisbon modernisation programme launched in 2000 that focuses on growth and employment. The other scenario runs the risk of Member State interests overriding those of the Community, risking or wiping out results achieved so far in the single market, the common currency, the regulation of competition and in Community policies. These potential outcomes are clearly not independent from the readiness and commitment of the individual Members States to Community solutions.

Although the crisis affected the entire European Union, one can still clearly distinguish two different groups of countries in terms of the objectives and instruments of crisis management. One group contains the economies of the EMU, while Member States either opting out of the EMU or those still waiting in line belong to the other, the latter predominantly being new Member States. The United Kingdom, Sweden and Denmark are formally outside the EMU, but being developed market economies their status within the EU is determined by completely different aspects to those affecting Central and Eastern European countries which converted to market economies once the Soviet influence on their economies receded.

Economic Development in Central Europe since EU Accession

International economic relations of countries in Central Europe underwent radical change between 2004 and 2007 on account of the two enlargement waves of the European Union, creating new conditions for economic development and convergence. EU accession lent new momentum to the economic growth and therefore convergence of all the new Member States – with the exception of Hungary, where the initially higher rate of growth had slowed substantially by 2007, while living standards measured in terms of per capita GDP have merely stagnated since joining the EU in contrast to the dynamic growth recorded in the other nine countries. On the whole the region developed at a pace rarely seen in economic history, which accelerated the pace of convergence, though it will be practically impossible to repeat this in the near future. The economies in the region have to formulate a radically different economic strategy under the new domestic and international conditions. During this period of rapid expansion, however, the sustainability of growth registered by the various countries differed, and therefore the crisis found the EU Member States in Eastern Europe in very different situations.

In terms of per capita GDP, the Baltic States and Slovakia have made the greatest progress since 1998. Over this 11-year period, the three large new Member States of Hungary, the Czech Republic and Poland have trodden similar paths, converging 8-10 percentage points on the EU-15 average. Between 1998 and 2008 the regional ranking of countries underwent significant change: while Estonia, Lithuania and Slovakia managed to improve their relative positions, Hungary and Poland steadily worsened.

If we just examine the indicators for 2003, i.e. the year prior to accession, the trends perceived are largely similar, with the difference that Hungary's development deviated at a tangent from the other countries in the region and between 2003 and 2008 did not manage to converge on the EU-27 average at all. This catch-up process is reminiscent of Greece, where practically no convergence was achieved for almost fifteen years after accession.

Taking into account the growth processes predicted for the next 2-3 years we can expect further substantial restructuring between countries. The Baltic countries will lose a considerable part of the convergence they achieved over the last decade, while the Czech Republic and Poland will manage relatively swift convergence, just ahead of Slovakia. Any form of catch-up will continue to elude Hungary and Poland may well leapfrog Hungary in the regional rankings.

Per capita GDP of the "new Member States" Per capita GDP, PPP, EU-27=100; Change 1998-2008 percentage point; Change 2003-2008 percentage point; Change in order between NMS (1998-2008)

Per capita GDP of the "new Member States"

	Per capita GDP, PPP, EU-27=100;			Change 1998-2008 percent. point	Change 2003-2008 percent. point	Change in order between NMS (1998-2008)
	1998	2003	2008			
Slovenia	77.7	83.4	90.7	+ 13.0	+7.3	1 → 1
Czech Republic	70.5	73.4	80.1	+ 9.6	+6.7	2 → 2
Slovakia	52.1	55.5	71.9	+ 19.8	+16.4	4 → 3
Estonia	42.5	54.5	68.2	+ 25.7	+13.7	6 → 4
Hungary	54.6	62.8	62.8	+ 8.2	0.0	3 → 5
Lithuania	40.4	49.1	61.1	+ 20.7	+12.0	7 → 6
Poland	47.8	48.9	57.6	+9.8	+8.7	5 → 7
Latvia	35.6	43.3	55.8	+ 20.2	+12.5	8 → 8
EU-15	115.4	113.7	110.8			

Source: Eurostat and own calculation

The regional economies contracted to varying degrees in 2009, but overall we saw plummeting economic performance; as a result, per capita GDP figures have changed to almost unprecedented extents, which in turn trigger significant shifts in the relative development levels of the individual countries.

The crisis is unleashing its power the most in the Baltic countries which previously recorded the most dynamic growth rates; all three of the economies were suffering from a severe and far deeper recession than all of the other new Member States. At the beginning of the 1990s and after suffering economic downturns reaching almost 50% of GDP the Baltic countries announced stabilisation programmes which centred around stable exchange rates; this is why they pegged their exchange rates to a key currency or to a basket of currencies. The macroeconomic imbalances were substantial even by Eastern European standards. These equilibrium problems primarily arose in the current account and resulted in double-digit deficits relative to GDP for years, but the benign conditions for the international flow of funds and the low cost of capital meant that this was not an issue; today, however, the situation is rather different. The significant external deficit is partly caused by the economic convergence process, but its size has raised questions about sustainability for years. As the crisis deepened and the flow of funds dried up the current account balance started to improve rapidly, which cast the external equilibrium in a better light as well, even though economic output had fallen by about one fifth.

With monetary policy being useless it is theoretically fiscal policy that can mitigate the economic impacts, but the economic decline was such that to compensate for the falling revenues governments have been forced to cut back massively on budgetary spending (up to 10-20% of GDP). The crucial issue is what to do with the pegged exchange rates? Pressure to devalue the regional currencies had grown, but abandoning the peg implies huge risks. While it is clear that such a step would be justifiable in many respects given the difficult economic circumstances, it would tip many businesses and households into bankruptcy. Loans "defaulting" en masse would accelerate the deterioration in banking portfolios, while the reduced solvency of households and companies could trigger an even greater economic setback that would bring down the Scandinavian banks in the region with it, thereby creating a catastrophic situation for the economies of these northern countries. Euro introduction became a viable option in the case of Estonia which became the next candidate for Euro adoption. The other two Baltic States however still have a long way to go.

From a certain perspective the economic development in the countries of South-Eastern Europe, including Romania and Bulgaria, followed the model of the Baltic States. Bulgaria has a similar exchange-rate regime and both countries have witnessed the emergence of significant current account deficits in the years just before the crisis erupted, which paved the way for the rapid growth. In addition to inexpensive international funding, the money repatriated by Bulgarians and Romanians working abroad played a significant role in financing this deficit, which was an important factor from the perspective of domestic consumption. This is why the economic downturn has been exacerbated by the fact that not only has the flow of international loans dried up, those who have lost their jobs in Western Europe are now not able to send as much money home either, which again impacts adversely on domestic demand. What is more, the return of these workers only serves to increase the level of unemployment.

Surprisingly for many, the Euro area members of Slovenia and Slovakia were heading towards an increasingly severe downturn in growth in comparison to what was previously expected. Slovakia's opportunities for growth were very much limited in the current situation by the country's vulnerability linked to its one-sided economic structure. The automobile industry is very sensitive to cyclical trends, and the crisis has hit this sector extremely hard, even in spite of the measures taken by governments in many countries to stimulate demand. In the long run it may even be questionable just how much an economic structure based on the car industry will be capable of reaching previous levels of growth. However, the picking up of international demand in 2010 resulted in a positive change in GDP growth prospects. In Slovenia which focuses strongly on exports, the dramatic decline in external demand accelerated the economic downturn. Since the country is very open in terms of foreign trade and its growth essentially depends on exports, the general plunge in demand has very much limited the growth opportunities of such a small open economy.

In comparison to the region of Central and Eastern Europe, the Czech Republic and Poland have relatively stable fundamentals and the crisis hit them as they enjoyed a period of benign economic conditions. In Poland, managing the crisis does not take on the form of bank bailout packages or international loans linked to economic conditions but in continuing the structural reforms that had already been launched. However, this only partly explains the endurance of the country vis-à-vis the crisis, what is even more important is that it has a very large domestic economy by Central European standards and relatively speaking is less open, which means changes in international demand do not affect it as much; additionally, domestic demand together with the domestic market are able to mitigate the pace of the economic slowdown. Nonetheless, the fact that the IMF provided Poland with a flexible credit facility in spring 2009 to overcome any unexpected financial difficulties just demonstrates the unpredictable and increasingly severe consequences of the crisis. It is important to note that this credit facility can be used at any time and is not tied to any conditions, i.e. it is only there as a safety net.

The Czech Republic does enjoy its relatively stable macroeconomic conditions, but here, external demand is much more important than for Poland which is why the Czech economy is set for much more challenging times over the coming period than the Poles; however, given the features of the economy it is now likened more to the healthier Poland than to other economies in the region.

Hungary does not really "stand out" from the other economies in Central Europe in terms of expected growth. Yet because of the country's vulnerability and the level of its debt it is more often than not grouped with the Baltic countries. For this reason there were no reserves which could provide more options for the budget, as is the case in more stable countries (such as the Czech Republic and Poland), nor are there any tools available to stabilise the situation, such as the Euro in Slovakia and Slovenia, while the domestic market is too small to stabilise demand on its own. What should not be forgotten is that thanks to the stabilisation measures taken, demand had narrowed significantly and the economy had slowed down in Hungary even before the crisis erupted.

GDP Growth and Forecasts for the New Member States

	2004	2005	2006	2007	2008	2009	2010*
Bulgaria	6.7	6.4	6.5	6.4	6.2	–4.9	–0.1
Czech Republic	4.5	6.3	6.8	6.1	2.5	–4.1	2.4
Estonia	7.2	9.4	10.6	6.9	–5.1	–13.9	2.4
Latvia	8.7	10.6	12.2	10	–4.2	–18.0	–0.4
Lithuania	7.4	7.8	7.8	9.8	2.9	–14.7	0.4
Hungary	4.5	3.2	3.6	0.8	0.8	–6.7	1.1
Poland	5.3	3.6	6.2	6.8	5.1	1.7	3.5
Romania	8.5	4.2	7.9	6.3	7.3	–7.1	–1.9
Slovenia	4.3	4.5	5.9	6.9	3.7	–8.1	1.1
Slovakia	5.1	6.7	8.5	10.5	5.8	–4.8	4.1

Source: Eurostat /* Eurostat forecast.

The course of the crisis largely depended and still depends on the flow of funding. It is very difficult to judge just how the banking systems in Central European countries will remain stable while it becomes more difficult to source funding on the international markets on account of the decline in global savings and the rise in the external financing requirements of the world's largest economies.

We cannot rule out this scenario exerting its greatest impact in the Central European region. It is already difficult and sometimes even impossible to source funds on the international market, but this may get worse given that the growing problems for international companies means the future of subsidiaries is increasingly uncertain. Since developed countries do all in their power to preserve domestic jobs whilst companies concerned are coming under increasing pressure to slash costs, it seems logical to narrow the activities of subsidiaries operating in Central Europe in the next phase of the international crisis. On the other hand however, the lower cost of production in this region makes it very competitive against the production in more developed countries where the wage level is also higher. So the picture on production and investment prospects in international comparison is not black and white.

From the perspective of growth and convergence based on both internal (investments, consumption) and external (capital flows, trade) factors it is evident that the new Member States which have coped better with the crisis so far are those which have produced high but not overheated growth since accession coupled with an appropriate level of external and internal financial stability, a low budget deficit and a healthy public debt indicator. In the case of Poland an additional factor prevented larger downturn. In other countries in the wider Central European region the credit based consumption and investment was much widespread than in Poland where the financial deepening was slower. In other states where credits were the most important factors for increasing demand the sudden stop of in the financial market resulted in a demand shock, or in other words the over consumption had to be adjusted to the available income. This shock was much bigger in other countries than in Poland.

The economies in the Central European region are supposed to formulate a different economic strategy under the new domestic and international conditions. This strategy seems to be different from the previous one in two aspects. The first is that achieving fiscal balance becomes a number one priority, and second that the growth should much more be based on savings rather than easy credits. These changes are affecting the region's countries differently, because of the not uniform initial position, but the mainstream of the "new" economic policy points toward these directions.

The expectation for post accession period was that the need to comply with the Maastricht criteria pushes the Central European countries to decrease the economic disparities between their countries and the former EU Member States. The indirect harmonisations of economic policies were supposed to be a tool to support convergences between their economies. In the longer run it is certainly true that outside pressures help indirectly certain convergence of economic policies between the Visegrad countries independently from economic policy coordination. This coordination has been almost non-existent during the past two decades and only under serious (economic) security policy threats could alter the situation. This is exactly the case currently; however the developments in the region hint that the tools chosen by the regions' countries are different and the dividing line is again between Hungary and the others.

Except for the Slovak and Slovene economies, the countries were unable to meet the prerequisites for introducing the single currency even before the crisis. The consequences of the crisis, however, have pushed the fulfilment of the requirements even further away, especially if the current Maastricht criteria remain in force. Their relevance was questioned by many even before the crisis, as aspiring countries are expected to comply with conditions that the EMU countries themselves fail to fully abide by. What is more, commitments made in the convergence programmes – restrictions relating to a sustainable balance, financial regulation, oversight, interest rates and exchange rates in particular – have, in the short run, narrowed the crisis management alternatives for the countries waiting to join EMU.

The crisis highlighted the benefits of exchange rate stability guaranteed by the single currency for the countries in the region. The majority of these economies are extremely open in terms of foreign trade, while export ratios relative to GDP are high and most of their foreign trade is with EU markets. Some countries (Hungary and Poland) are experiencing massive corporate and household indebtedness in foreign currencies, which only adds to their vulnerability. Due to their export sensitivity and their dependence on external funding, the global recession made their position even worse; and from September 2008 investors hastily withdrew their capital from the region. All of these factors combined with speculation attacks against certain currencies and listed companies led to dramatic falls in exchange rates and great volatility. Had it not been for the financial assistance of the IMF, the World Bank and the European Union, Hungary and Latvia would have been unable to avoid a financial collapse, maintain the funding of their budgets or stabilise their currencies.

Despite the global crisis seriously threatening the financial stability and currencies of the Central

and Eastern European countries waiting to introduce the Euro, neither the European Union, nor the EMU or the ECB showed any willingness to grant them protection under the common monetary policy. It was the IMF which proposed that the countries in the region afflicted by the crisis should get rid of their national currencies and introduce the Euro instead, without formally joining the Euro area. This would have been quasi membership, but without membership of the ECB Board. In addition, the IMF and the EBRD tried to persuade the EU and the Central and Eastern European countries to work out a regional crisis management strategy and set up a regional financial rescue fund, which encountered widespread resistance from both sides and so the issue was dropped from the agenda. Joining the Euro area was opposed not only by the ECB but also by the EMU countries, as they did not wish to water the Maastricht convergence criteria down.

As suggested by analyses, the crisis has pushed the aspiring countries even further away from fulfilling the formal convergence criteria. Addressed to the new EU Commission, the Bruegel Report underlines in terms of the enlargement of the Euro area that the Maastricht criteria set forth in the early 1990s are contradictory and the crisis has finally rendered them unfit for purpose. Therefore a new procedure, clear requirements and economically reasonable benchmarks (performance evaluation) need to be set to replace today's mostly irrelevant conditions. This should be offered to the countries wishing to join the club, but we should also acknowledge Member States wishing to delay the introduction of the Euro. In the years preceding the crisis the reference value of the budget deficit set at 3% of GDP was exceeded most by Hungary and Poland. As a result of the strict budget consolidation launched in Hungary to redress the balance and pave the way for sustainable growth, the deficit was successfully curtailed. Due to the high Hungarian indebtedness, fiscal policy has very few opportunities left to provide massive budgetary funding for crisis management measures. In Hungary the visible government aim at the moment is to stabilise the public finances with revenue increases which is based on additional sectoral taxes, the channelling private savings in the pension system into the budget and at the same time cutting income taxes both for households and the corporate sector. In short run the Hungarian budget position due to these steps will be in order but the longer term consequences are not seen at the moment. The sustainability of the public finances and also the transfer system (pensions, social transfers etc.) will be questionable after 2012-2013.

Revenue side stabilisations were rarely successful in the past 15-20 years in Europe. The mainstream stabilisation efforts in Europe and that are followed in other Visegrad countries as well is much more based on the spending side. This difference explains that the future budget position and debt risk in Hungary and in the other three Visegrad countries is judged differently by the international actors at the moment. This is clearly reflected in the recent Moody's downgrading of Hungary' sovereign debt putting it into Baa3 category while Czech and Slovak ratings are A1 and Polish is A2.

What can be an interesting feature for each of the Visegrad countries are the changing international strategies of global firms. Many firms are forced to search for further cost cutting in order to regain their competitiveness in face of an economic environment where demand is several sectors is expected to stabilise at a lower level than before the crisis broke out. In such circumstances firms are eagerly looking for cost saving measures that in large firms may result in rethinking their global presence that leads to closing high cost production facilities and move them partly to lower cost countries. As big multinationals in some cases are deterred to close facilities in their home countries (because of government warnings i.e. in some major Western European countries) they may chose to downsize their production in other high wage countries. Visegrad countries are low cost locations and the capacities in some sectors (car industry for example) are technologically modern, very competitive so they can expect some additional investment as part of global cost optimization strategies of multinationals. It is by no means an accident that in Hungary we witnessed several additional investments from big car makers in recent months while future prospects of economic growth and fiscal stability are still not very bright. And this phenomenon is very promising as this show that Central European countries as locations are attractive in international cooperation that can be an additional element in maintaining export oriented growth in Hungary, Slovakia and partly in the Czech Republic. Poland stands out a bit from the region as the size of its domestic market makes possible to rely more on the domestic demand instead of external one that is the major growth component in the other three countries from the region.

The Hungarian Economy and the Global Economic Environment

If we analyse the effects of global economic processes on Hungary, here and now, we cannot emphasise strongly enough that in spite of the many apparently favourable trends the global economic crisis is not yet over, because global economic processes are far from having created a (relative) balance.

1. All around the world, there are still huge superfluous productive capacities, which were accumulated during the past few decades by big companies themselves, and today they are partly maintained artificially by government bailout packages. Bigger real economic failures could still be round the corner. The structural change, 'the creative destruction' is not yet finished.

2. There will be strong demand constraints to an economic upswing for some time. The momentum of international trade is unusually dynamic for crisis times, but unemployment, the decreasing earnings of the population, the restraint of welfare spending, the deferral of government investments and the lag of business investments and housing construction is pulling demand back.

3. The solvency of retail and corporate debtors is weak, and in some cases the insolvency ratio is even growing.

4. This situation burdens bank portfolios and financial institutions may incur losses. The high funding needs of state budgets in developed countries mean that money market supply and risk-taking are still scarce. Lending continues to be very prudent, and companies, especially those in less developed countries, will find it harder and more expensive to obtain working capital.

5. Given the relative financial consolidation, many financial institutions have launched 'repackaged' derivatives with uncertain backing (e.g. the cash-for clunker loans in the USA).

6. The possibilities for financing and sustaining further countercyclical economic policies, governmental bailout packages and near-to-zero interest rates are narrowing. The risk of budget imbalances and insolvency is not just an issue for Greece.

7. The abrupt increase in government debts reinforces the possibility that they could eliminate them by inflating them, boosting general inflation.

8. The only moderate decline in the international trade and payment deficit of the USA remains a factor of tension in the global economy, as well as the general prevalence of international balance deficits, although these usually disappear during large crises. The same conclusions were drawn by the aforementioned Nouriel Roubini. He mentioned bubbles without foundations too, which could burst in 2010 or 2011, and feared that 'monetising large deficits' would cause inflation. Under such circumstances, a weak financial or macroeconomic figure could trigger major fluctuations. We agree with Roubini that the current crisis process is rather long – to use Mihály Simai's witty words, it will be the shape of a bathtub – and a new, deep wave could appear within it, forming a W-shaped crisis curve. And even if massive bailout packages, severe public debt and strong inflation could still help developed countries avoid the newer and deeper crisis wave for now, and if bigger bubble bursts can still be avoided, the presence of the unnecessary bubble capitals and their low return – in our opinion – will shorten the next economic cycle (relative growth and prosperity will be shortened to 3-5 years), and structural tensions will set a moderate tone for economic growth, at least in developed countries.

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