Economic solidarity with central and eastern Europe
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Since the collapse in autumn 2008 of Lehman Brothers, the highly successful and apparently smooth process of integration, growth and catch-up of the new European Union member states of central and eastern Europe (CEE) has suddenly started to look more fragile. The financial and economic crisis has hit hard many of the twelve countries that joined the EU in 2004 and 2007. Furthermore, CEE countries have been hit harder than the world's other developing and emerging economies. CEE countries can count on western Europe solidarity, but there is still a lot to do in both east and west Europe to avoid the emergence of new divisions between them.

Why have CEE countries been hit so hard? Although there are important differences between CEE countries (Figure 1), they have in common that many of them entered the crisis more vulnerable than other regions of the world. Many had borrowed heavily from abroad and were in the throes of huge housing and consumption booms. Consequently high current account imbalances emerged before the crisis (Figure 2). It is noteworthy that while Latin America was at the root of emerging market crises between the 1970s and early 2000s, Latin America was affected much less by the current crisis than eastern Europe mainly due to macroeconomic policy changes after the deep crises of the late 1990s and early 2000s.

The main reason for the vulnerability of CEE countries is related to their EU integration. There is no doubt that the fifth EU enlargement round was a great achievement. It overcame historical divisions in Europe, promoted democracy, the rule of law, protection of human rights, market-oriented reforms, and helped to preserve security and stability. The enlargement also brought higher GDP and prompted competitiveness for the whole EU, and increased its global presence. CEE countries hence benefited greatly from their integration into the EU. In economic terms, their trade with the old EU member countries increased rapidly, and they benefited from a huge amount of investment, including in local banks by big western European banking groups. All these factors contributed to fast economic growth before the crisis. Western European corporations and banks also made huge profits from their activities in CEE countries.

However, EU integration and pre-crisis fast growth engendered complacency in many economic actors about the risks inherent in large credit and housing booms, and current account imbalances. CEE countries felt ‘EUphoria’ and believed that their rapid income grow would continue, leading them to borrow against their future income. The crisis, however, revealed that fundamental economic laws remain in place even within an integrated EU. When growth is mostly fuelled by consumption, and is accompanied by outrageous housing booms, there is a risk of a substantial correction. The crisis amplified the correction that would have happened anyway, but the crisis also called into question the longer-term growth prospect of CEE countries.

Western Europe has showed solidarity with the troubled new EU member states, not just because of a realisation of common European values but also because it is in the interest of western Europe to have prosperity and stability in the east. Many western European corporations and banks have eastern subsidiaries and hence these corporations are directly affected by economic developments there. Loss of prosperity in the east may lead to more people moving west to look for work. While economic migration generally leads to an improved allocation of productive resources, thereby increasing global output (the eastern enlargement of the EU has been a success story in this respect as well), the protectionist mood is on the rise in western Europe as unemployment increases substantially.

Furthermore, western Europe shares to a great extent responsibility for the severity of the crisis. While the presence of major western European banking groups in the east has been beneficial both for the west and the east, these banks pursued rather aggressive lending strategies that contributed to the build-up of vulnerabilities in the east. Furthermore, in contrast to previous emerging market crises, the current crisis originated primarily from the behaviour of US and western European financial markets. In this sense western Europe has a moral responsibility for the depth of the east's crisis.

European solidarity toward eastern EU members manifests itself in many ways. However, it should be clearly stressed that solidarity does not imply the transfer of western taxpayers' money to the east in the form of aid, but of loans that have to be repaid with interest.

The EU has a medium-term financial assistance facility for the balance of payments of non-euro area EU member states. In response to the crisis the lending ceiling was increased from €12 billion to €25 billion in November 2008, and then to €50 billion in May 2009. Hungary, Latvia and Romania have received loans from this facility as part of a coordinated international lending programme conditional upon the implementation of comprehensive economic programmes aimed at ensuring fiscal consolidation, structural reforms and support for the financial system.

In response to the April 2009 G20 meeting, European governments committed to contributing $100 billion to the increase in IMF resources. Since the CEE region benefits more than any other from IMF assistance, part of this contribution will arrive in the region. Indeed, the coordinated international lending programme for Hungary, Latvia and Romania was headed by the IMF. The World Bank has also provided assistance to the three countries. It should also be mentioned that individual European countries, namely the Czech Republic, Denmark, Estonia, Finland, Norway, Poland and Sweden, have also contributed to the lending programme to Latvia. The European Bank for Reconstruction and Development (EBRD) directly contributed to both the Latvian and the Romanian programmes and the European Investment Bank (EIB) contributed to the Romanian plan.

The EIB and the EBRD substantially expanded their activities in the CEE region by recapitalising sound banks, expanding the trade facilitation programme, financing energy and infrastructure projects, and setting up a corporate-support facility. Jointly with the World Bank, the EIB and the EBRD launched an action plan to support with up to €24.5 billion over two years the CEE banking sectors, and bank lending to businesses, especially small and medium-sized enterprises. EIB and EBRD initiatives also relate to many other CEE countries.

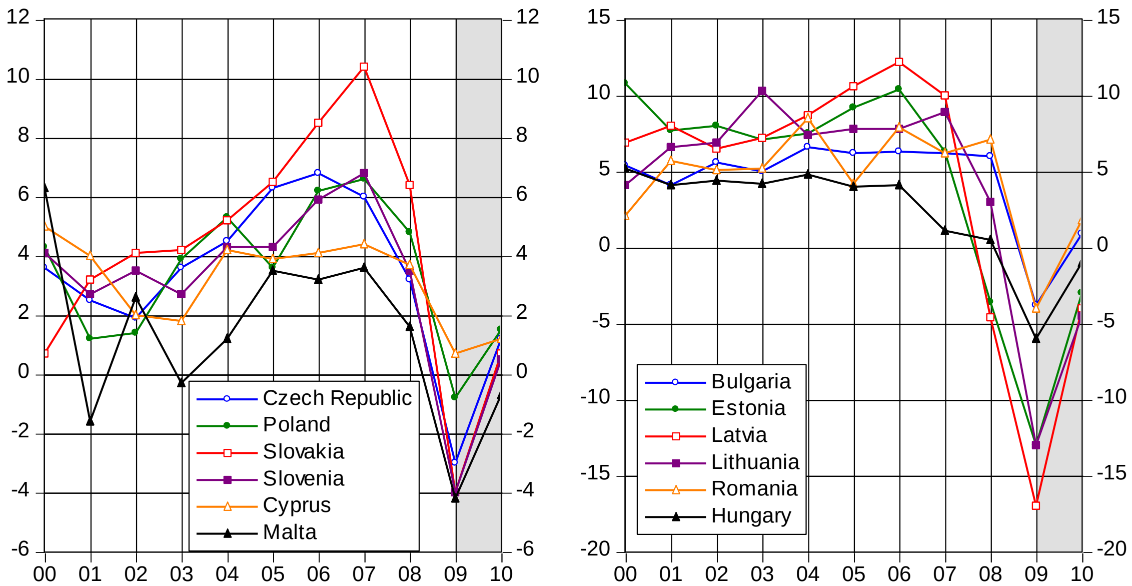
EU member states decided in response to the crisis to frontload the disbursement of EU structural and cohesion funds. Frontloading amounts to €11 billion of which €7 billion is for the new EU member states.

Less was done by the European Central Bank (ECB), which offered euro repurchase agreements to Hungary and Poland. Under these agreements the two CEE central banks can receive temporary euro liquidity in exchange for securities eligible for ECB transactions, such as euro-denominated government bonds. However, while the ECB offered swap agreements to Denmark and Sweden, it did not offer them to new EU member states, and while the ECB accepts non-euro denominated securities eligible for refinancing in three currencies (US dollars, British sterling, and Japanese yen, provided the security was issued in the euro area), it does not accept high-quality securities issued in new EU member states. These and other possible ECB supports for the troubled CEE countries would represent direct help to these countries and would, for CEE banks, be a substitute for the malfunctioning euro-area money market. But this assistance will also boost credibility, with all its associated consequences.

A change in attitudes toward euro introduction would also boost confidence. Many current euro-area member states had not met all of the Maastricht Criteria before their entry, but they were allowed to join nevertheless, mainly for political reasons. Thus the moral basis for insisting that CEE applicants rigorously meet the current criteria is not well grounded. Furthermore, the case for reforming the Maastricht Criteria was strong even before the crisis. Now, after a serious asymmetry of unpunished fiscal profligacy in euro-area member countries and painful austerity in euro-area applicant countries has emerged, the case is even stronger. An effective reform would not affect the stability of the euro area, but would help kick-start the inflows of private capital – not of western taxpayers' money – that these countries desperately need.

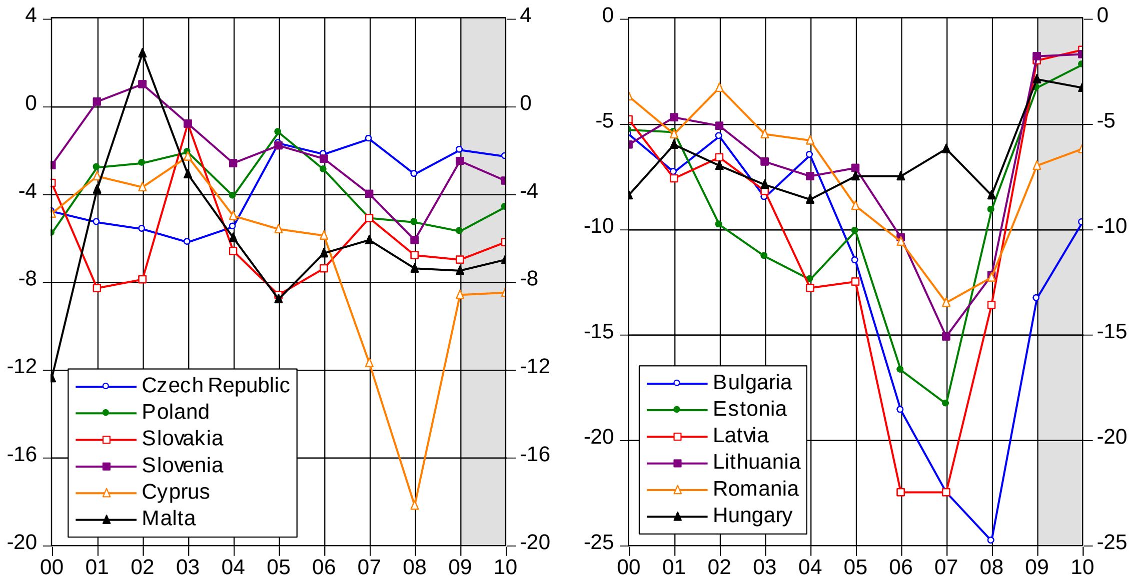
Meanwhile, for some new member states, the case for implementing long-needed but always-delayed structural reforms is very strong. The external financial constraints posed by the crisis present the best opportunity since transition to implement these reforms.

Figure 1: GDP growth, 2000-2010



Source: Forecasts for 2009 and 2010 are from the April 2009 forecast of DG ECFIN.

Figure 2: Current account balance (percentage of GDP), 2000-2010



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