Eastern European economies face bankruptcy

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The economies of central and eastern Europe are being rocked by the crisis of world capitalism, compounded by the corrupt and pro-big business policies of their local elites.

Defying many economists and commentators, who had forecast that the region would be well placed to deal with the credit crisis due to the lower relative weight of finance capital within their national economies, much of Eastern Europe stands on the verge of insolvency and deep and protracted recession.

Following the collapse of the Soviet Union and the Stalinist states, central and eastern Europe provided global capitalism with vast new sources of cheap labour and raw materials. In the early 1990s the recession affecting the Western economies, accelerated the flow of capital into the former-Soviet countries, with transnational corporations seeking to cut costs by outsourcing to this newly opened-up low tax, cheap labour areas.

Major global manufacturers such as General Motors, Volkswagen and Nokia invested hundreds of millions of dollars into new factories, taking advantage of the large pools of highly-skilled and educated workers, many of whom had lost jobs in the old state-owned industries that were closed following the restoration of capitalism. Western financial institutions profited from financing the development of new industrial plants, as well as property speculation among the new bourgeois elite and foreign investors in major urban areas like Prague, Warsaw and Bratislava.

Business consultancy, Capital Economics, reports that 17 years after the restoration of capitalism and four years after most joined the European Union (EU), wages in the eastern EU states are still only one fifth of the average of those in Western Europe.

An estimated five million workers have left the eastern European countries for Western Europe between 2004 and 2007. The mass migration from the ex-Soviet states has left key sectors of the economy and public services such as healthcare critically short of skilled workers. Poland and Ukraine almost had to abandon their status as co-hosts of the 2012 European Football Championship due to the chronic shortages of labour needed to renew facilities for the competition.

Only a few months ago, a recession in Western Europe was viewed as a potential boon to overheated Eastern Europe economies. Inflation, running at 15 percent in Russia and Latvia, seemed to be the greatest threat. However, as the full impact of the global crisis unfolds, the alleged ability of Eastern Europe to weather the storm relatively better than its Western counterparts has been thrown into question.

All the economies of the eastern European region are highly dependent on credit from the international markets. The Institute of International Finance has estimated that total private capital and credit flows into eastern Europe, the former USSR and Turkey, are likely to fall from nearly $400 billion in 2007 to an estimated $262 billion next year, a figure which may fall even further as it is based on optimistic forecasts of the effectiveness of the international governmental bailouts of the banks.

Erik Berglof, chief economist of the European Bank for Reconstruction and Development, stated that the eastern European countries, "could deal with rising borrowing costs and an economic slowdown coming from the US and Western Europe, but a complete shutdown of international borrowing—nobody can withstand that."

The International Monetary Fund forecasts a fall in the growth rate for gross domestic product (GDP) for central and southeast Europe from 5 percent this year to 3.5 percent in 2009. For Russia and the former Soviet Union, it predicts growth of around 7 percent for this year and 5.5 percent for 2009.

Emergency bailout for Hungary

Even these figures fail to show the full impact of the economic crisis on countries whose economies are heavily dependent on exports to the wealthier western EU.

The impact of a recession in France, Germany and Britain will be acutely painful to the eastern economies of Europe. The Czech Republic, for example, relies on exports to the wealthier euro currency zone for 40 percent of its GDP. As the British magazine, the Economist, stated, "If Germany gets a headache, eastern Europe gets a migraine."

On October 16, the same day countries across the EU pledged to shore up the banking system with a package whose total could exceed €2 trillion, the European Central Bank (ECB) granted Hungary a bailout worth €5 billion, saving its economy from a financial meltdown.

The International Monetary Fund (IMF) is poised to offer the country a further, and probably much larger, bailout loan.

Last week, Hungary put tight controls on foreign exchange lending in an effort to stabilise the country's troubled financial sector. This prompted a massive drop in the value of the Hungarian currency and stock market, quickly followed by sharp rises on the news of the ECB bailout.

Hungary has a very high level of foreign public debt—60 percent of GDP—meaning that the country is less attractive to foreign investors and less creditworthy to private and international lenders. Global credit ratings agencies Fitch and Standard and Poor's have lowered Hungary's rating to BBB+ , the third lowest investment grade offered to any country.

In addition, many ordinary citizens and local firms have loans with Hungarian banks that have been packaged in complex schemes based on the speculation that the Hungarian forint would stay on the same exchange rate as the euro. That situation is likely to change as Hungary's high budget and current account deficits pressure the devaluation of its currency, which is now trading at a two-year low, further destabilising its banking system.

The government of Prime Minister Ferenc Gyurcsany has reduced its official GDP growth forecast for 2009 from three percent to just 1.2 percent, and has acknowledged it is planning a budget based on a zero percent growth rate next year. The Hungarian government has pledged to cut its budget deficit, meaning that public services spending and wages will be driven down.

Nick Chamie, of RBC Capital Markets, has warned that much of eastern Europe is ill-equipped to bail out the financial system and may suffer the same fate as Iceland, whose financial system has seized-up with the collapse of its three major banks.

“The three Baltic states along with Ukraine, Kazakhstan, Bulgaria and Romania—and of course Iceland—are top of the list,” of those vulnerable to an investment exodus, Chamie warned.

Baltic states in crisis

Latvia and Estonia are officially the first economies in the eastern EU to fall into recession. Lithuania, whose growth has been slower than its Baltic neighbours, is likely to officially enter a recession in early 2009 and has been forced to guarantee the deposits of savers up to the value of €100,000, double the average EU guaranteed amount.

The Lithuanian prime minister was forced to appeal for calm in early October, stating that “There is no danger for any Lithuanian bank to go bankrupt. We monitor the situation constantly.” The country’s banking sector is dominated by the Swedish bank SEB.

The heads of government of all three Baltic states issued statements October 10 insisting that their countries were not headed for insolvency. “It is impossible to compare Lithuania with Iceland,” Prime Minister Gediminas Kirkilas told a joint news conference with his Latvian counterpart.

Reinhard Cluse, “emerging Europe” economist for Switzerland’s UBS bank, was more cautious, stating in response to the financial situation in the Baltic states:

“Iceland was a special case, but the same rising waters that flooded Iceland first are a problem for others, too.”

The three countries have seen an explosion of credit fuelled by property speculation over the past decade, while current account deficits have soared to among the highest in Europe. In Estonia, domestic and foreign debt stands at twice the country’s GDP, leaving it heavily exposed to the problems of bad debt that have beset the global financial system. Property prices in the capital Tallinn, have fallen by one quarter since 2007 and home foreclosures are on the increase.

“There are going to be some pretty big casualties in property-related sectors and retail,” warned Joakim Helenius, head of Tallinn based investment group Tigon Capital.

In Latvia, the central bank had to intervene this month to prop up its currency with public funds. The cost of bailouts, combined with falling domestic tax and customs revenues, mean that all three states are likely to suffer large budget deficits next year. The Latvian Central Bank estimates its government’s overspending to be 5.5 percent of GDP in 2009.

This will force government borrowing, bringing with it demands from international lenders that state budgets be slashed. The EU budgetary commissioner has already condemned Lithuania's draft budget for 2009 as far too high and has demanded that President Valdas Adamkus refuse to sign it into law.

Meanwhile, the increase in government indebtedness of these tiny countries, with limited resources to draw upon, will likely restrict investor confidence, further deepening recessionary pressures.

The banking sector in the Baltic states is dominated by Scandinavian capital. Swedish company Swedbank has seen a 50 percent fall in its share value, largely due to its heavy exposure in the Baltic countries, while its credit rating has been slashed. Swedbank expects profits from its Baltic subsidiaries to be cut in half in 2009. Swedbank maintains it and other banks will continue to pump credit into the Baltic markets in order to prevent an economic crisis there from spreading into Scandinavia.

Poland, Slovakia and the Czech Republic

Bulgaria and Romania, who joined the EU in 2007, are also in a highly precarious position. Citibank's evaluation cited their high vulnerability to financial instability. Bulgaria already has a national deficit of 21.5 percent of GDP. This figure is likely to rise as Hungary borrows from international lenders such as the European Central Bank and the International Monetary Fund to save its banks, and the government itself, from insolvency.

Poland, Slovakia and the Czech Republic are widely portrayed as being in a better position than most other states in the region, with less dependence on loans from foreign finance capital. They are, however, highly dependent on direct investment from transnational corporations and sales of manufactured goods and services to Western Europe.

The three countries have become major centres of manufacturing for the EU market, with the Polish and Czech economies booming from the development of plants making cars, electrical equipment, household goods and industrial plant largely for sale to Western Europe. Slovakia has become a virtual single auto-industry state, with the major automobile manufacturers closing factories in Western Europe and relocating tens of thousands of jobs there in an effort to slash wages.

While the foreign direct investment (FDI) that Poland, Slovakia and the Czech Republic are heavily reliant upon, is due to rise modestly to $90 billion across Eastern Europe in 2009, this figure represents a small fraction of total investment capital which has sharply contracted. FDI could freeze up next year if cash strapped companies hoard their resources in the event that global finance credit remains in limited supply.

With exports of commercial and domestic manufactured goods to Western Europe likely to fall over the coming period, combined with greatly restricted credit, even the relatively stable economies of the ex-Soviet region are likely to be plunged into recession.

Shares on the Polish stock exchange are trading at less than half their peak. Poland has mirrored the steps taken across the EU, pouring public money into a bailout of its banks.

Ex-Soviet regime

To the east of the EU member states, the situation could prove to be even worse. Russian authorities have set aside nearly $200 billion (€149 billion) for a financial market rescue.

Despite the relatively small size of its financial sector, which has assets valued at just 65 percent of its GDP (compared to 250 percent of GDP for banks in the euro zone), the country is highly dependent on foreign finance capital to fuel growth.

Over the past decade hundreds of small banks have emerged, fuelled by debt borrowed from major Western financial institutions and used to pay for developments in certain industries and construction in the booming property sector in Moscow and other large cities.

The Medvedev-Putin regime in Russia has injected $700 billion into its financial system, a greater amount than the United States or most western EU states as a portion of GDP. This massive increase in state spending has been made even more dangerous to the Russian public finances by the sharp fall in the price of oil, which has halved from its peak earlier this year.

A similar story is taking place in Ukraine, where foreign finance has been heavily relied upon to boost growth in industry and commercial property construction. Like Russia, the Ukrainian economy is now faced with the double blow of greatly restricted access to Western finance combined with plummeting prices for its main industrial exports, especially steel.

The Ukrainian stock market has lost over three-quarters of its value in a year.

Ukraine's central bank has been forced to prop up most of the country's financial institutions with state funds, while a run on the country's sixth largest bank, Prominvest, was caused by warning that it was likely to collapse.

The possibility of providing a stimulus to the Ukrainian economy by cutting interest rates, as has been put into effect across Europe and in the US, is limited by the fact that inflation is currently running at 25 percent. The Ukrainian Prime Minister, Yulia Tymoshenko, has requested a large loan from the IMF of up to $14 billion to shore up the economy.

US credit ratings agency Fitch downgraded Ukraine last week, stating:

"The downgrade reflects Fitch's concern that the risk of a financial crisis in Ukraine involving large depreciation of the currency, further stress in the banking system and significant damage to Ukraine's real economy is significant and rising."

Tymoshenko is in a bitter political struggle with President Viktor Yushchenko, who has called early parliamentary elections for December in an effort to unseat his rival. Both former leaders of the "Orange revolution" are blaming each other for Ukraine's economic woes. Tymoshenko has condemned the calling of fresh parliamentary elections, the third in three years, as a destabilising factor in the current economic crisis. She warned that all politicians must put aside "political ambitions" in an effort to bail out the economy at the expense of other areas of budgetary spending.

"We have to revise the state budget for the year 2008, and completely alter the draft state budget for 2009, because the whole world, and Ukraine as well, will see a certain stagnation of production, a certain fall of GDP growth, and, I think, the country will suffer the biggest blow in 2009. It means we have to transfer to a saving budget in 2008 and 2009," Tymoshenko told the Ukrainian parliament on October 13.

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