THE IMPACT OF THE FINANCIAL CRISIS ON THE CENTRAL AND EASTERN EUROPEAN COUNTRIES

The eight EU countries in central and eastern Europe outside the euro area (CEE) were strongly affected by the global financial crisis. However, the impact of the crisis varied significantly across countries. While Poland weathered the crisis relatively well, others experienced a considerable decline in GDP, and the Baltic States, which were already in recession before the failure of Lehman Brothers, faced a double-digit contraction in economic activity in 2009. These observed variations relate partly to the cross-country cyclical differences before the intensification of the crisis in September 2008 and, more crucially, the varying degrees to which countries had built up external and internal imbalances and vulnerabilities prior to the crisis. In addition, cross-country differences with respect to sectoral and regional trade specialisation and financial factors played a role. Policy responses to the crisis have also varied significantly across countries, mainly reflecting differences in the scope for manoeuvre – both on the fiscal front and on the monetary policy front.

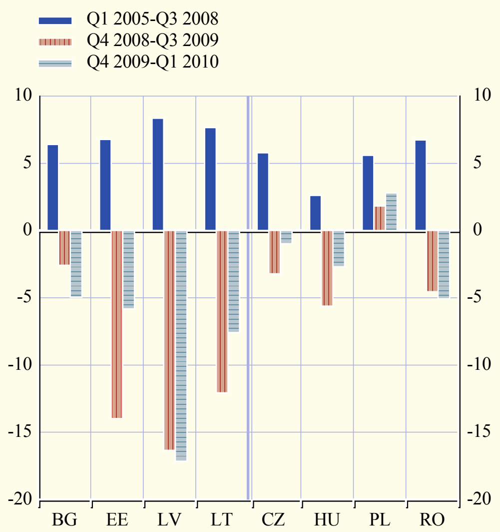
1 IMPACT OF THE CRISIS ACROSS COUNTRIES – STYLISED FACTS

When the global financial and economic crisis intensified after the collapse of Lehman Brothers, the CEE countries were strongly affected, as reflected, for example, in a significant decline in GDP growth. Although they had been relatively resilient until September 2008, the CEE countries suffered as a result of heightened risk aversion on the part of international investors towards the CEE region, general deleveraging by financial institutions and a marked contraction in foreign demand. But the impact of the crisis on GDP growth varied considerably across countries. While Poland weathered the crisis relatively well, being the only EU country to record positive GDP growth in 2009, others experienced a considerable decline in GDP, with the Baltic States even recording a double-digit contraction in economic activity (see Chart 1).

In general, those countries that had grown particularly strongly in the years before the crisis, namely Bulgaria, the Baltic States and Romania, have subsequently seen the largest declines in output. Three of the CEE countries, namely Latvia, Hungary and Romania, also had to request EU and IMF-led international financial assistance as a consequence of the crisis. Cross-country cyclical differences, while already pronounced before the crisis, as compared, for example, with those in the euro area countries, seem to have increased further following the crisis. Moreover, not only the size of the impact varied across countries, but also the timing and speed at which countries were affected by the crisis. In the Baltic States, GDP growth had already started to slow well ahead of September 2008, while in Hungary economic activity started to contract in annual terms at the end of 2008. In Bulgaria, the Czech Republic and Romania, annual output growth was still

Chart 1 Real GDP growth

(average annual growth rates; quarterly data)



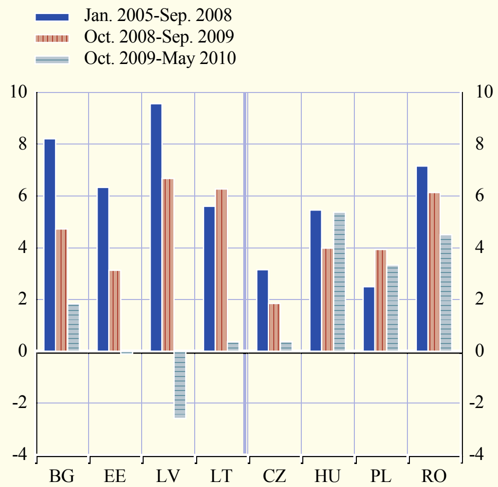
Source: Eurostat.
Notes: Data are working day and seasonally adjusted except for Bulgaria (no adjustment) and Romania (only seasonally adjusted). Data for the first quarter of 2010 are not available for Latvia. Countries to the left of the centre line have fixed exchange rate regimes or currency board arrangements. Those on the right have more flexible regimes with the central banks pursuing inflation targeting strategies.

relatively robust in the fourth quarter of 2008, but turned negative in the first quarter of 2009. For most countries, the trough of the decline in output occurred in the third quarter of 2009, therefore, this article analyses the impact of the crisis in the period from the fourth quarter of 2008 to the third quarter of 2009. Owing mainly to a recovery in foreign demand, the decline in economic activity slowed in most CEE countries in the first quarter of 2010, with the Czech economy even starting to grow again.

HICP inflation, which had increased strongly in most countries before the onset of the crisis, generally declined sharply thereafter, although the degree and pace of the decline differed across countries (see Chart 2). The drop in inflation reflected mainly a decline in global commodity prices, lower wage growth and a sharp fall in domestic demand. The sharpest drop in inflation was experienced by Bulgaria and the Baltic States. These countries were still recording double-digit inflation rates in September 2008, before inflation declined to zero or in some cases even turned negative just

Chart 2 HICP inflation

(average annual growth rates; monthly data)



Source: Eurostat.
Notes: Countries to the left of the centre line have fixed exchange rate regimes or currency board arrangements. Those on the right have more flexible regimes with the central banks pursuing inflation targeting strategies.

over one year later. Inflation has started to increase in recent months in a number of countries, while Latvia was the only CEE country still displaying negative inflation rates in May 2010.

2 IMPACT OF THE CRISIS ACROSS COUNTRIES – UNDERLYING CYCLICAL AND STRUCTURAL FACTORS

PRE-CRISIS MACROECONOMIC IMBALANCES

To understand the cross-country differences in the impact of the crisis, it is important to first look at the cyclical positions of the CEE countries and the closely related macroeconomic imbalances existing when the financial crisis intensified in September 2008. In fact, the CEE countries were in very different cyclical positions when the financial crisis began. In the years preceding the crisis, a number of them, in particular the Baltic countries, grew rapidly, often at unsustainable rates, which led to a widening of the positive output gap and fostered the emergence of internal and external imbalances. Owing to strong capital inflows and credit growth – the latter fuelled by very low and in some cases even negative real interest rates – several CEE countries experienced strong rises in asset prices, in particular house prices. Wealth effects, in turn, further stoked excess demand pressures. In a number of countries, especially Bulgaria, the Baltic States and Romania, substantial wage increases, in some cases accompanied by rapid public wage growth, led to strong increases in unit labour costs. Expansionary fiscal policies also boosted GDP growth ahead of the crisis and led to significant structural budget deficits in 2007 in several countries, in particular the Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania (see Chart 3).

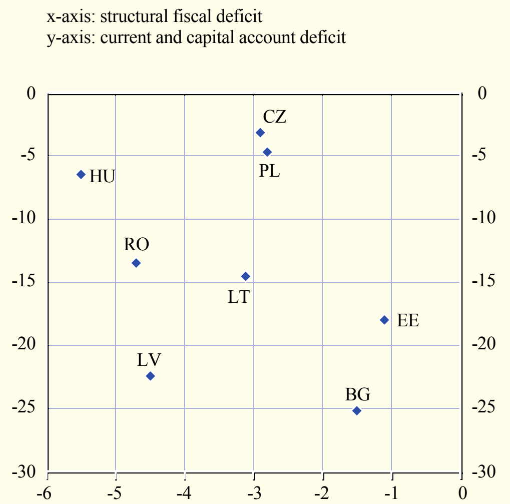
Rising domestic demand pressures eventually translated into escalating inflation and real currency appreciation in some countries. This, in turn, further exacerbated the widening of current and capital account deficits through an associated loss of competitiveness. As a consequence, external deficits reached double-digit GDP ratios in Bulgaria, the Baltic States and Romania before the crisis (see Chart 3), exceeding levels that could be explained by the countries' catching-up process alone.[1] The high current and capital account deficits contributed to the emergence of vulnerabilities, especially since a growing share of the countries' current account deficits was financed by capital inflows that added to the countries' external debt levels. In addition, several countries, in particular the Baltic States, reported that a large share of their external financing prior to the crisis took the form of "other investment" inflows. This is often perceived to be a less stable form of financing than foreign direct investment. As a result, external indebtedness and financing needs were at relatively high levels in many CEE countries, making them vulnerable to a change in investor sentiment.

Vulnerabilities to a change in investor sentiment and, in some cases, the associated currency depreciations, were further exacerbated in some countries by the fast build-up of a large stock of foreign currency denominated debt in the private sector, mainly in the form of mortgage loans. The increasing share of foreign currency lending in the CEE countries (for the most part denominated in euro) accompanied – and may in some cases have contributed to – a strong expansion in overall credit (see Chart 4). There were, however, important differences between countries. While there was a strong bias towards foreign currency loans in Estonia and Latvia (of around 80%), the share of foreign currency loans to the private sector in the Czech Republic and Poland was only around 10% and 25% respectively. The strong presence of foreign-owned banks and differentials between interest rates on loans in domestic and foreign currency were important factors in explaining the pattern of foreign currency lending in the CEE countries. Exchange rate-related factors and expectations regarding the

1 See M. Ca'Zorzi, A. Chudik and A. Dieppe, "Current account benchmarks for central and eastern Europe: a desperate search?", *Working Paper Series*, No 995, ECB, 2009.

Chart 3 Current and capital account imbalances and structural fiscal deficits

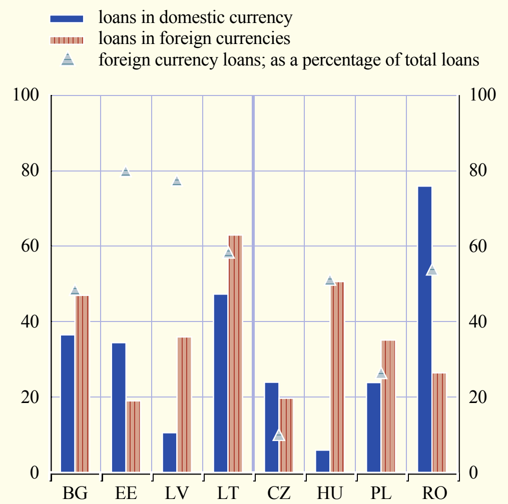
(percentages of GDP; 2007)



Sources: Eurostat and European Commission.

Chart 4 Growth of credit to the private sector

(average annual growth rates; January 2005-September 2008)



Source: ECB.
Notes: The share of foreign currency loans is calculated as an average of the period from January 2005 to September 2008. Countries to the left of the centre line have fixed exchange rate regimes or currency board arrangements. Those on the right have more flexible regimes with the central banks pursuing inflation targeting strategies.

adoption of the euro, especially in those countries with fixed exchange rate regimes in place, may have also played a role. The high exposure to sharp exchange rate movements implied major balance sheet risks for borrowers.

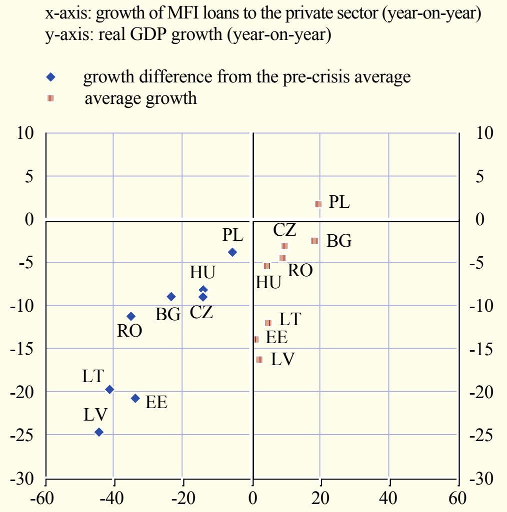
CROSS-COUNTRY DIFFERENCES IN THE FALL IN DOMESTIC DEMAND

The considerable decline in GDP growth that most CEE countries experienced after September 2008 was driven by both a collapse in exports and plummeting domestic demand. The turnaround from significant excess demand pressures to a sizeable fall in aggregate demand, with a rapid decline in inflation rates, was most pronounced in those countries that had experienced the strongest overheating pressures before the crisis and had allowed large external and internal imbalances to build up, as described above. These countries were particularly severely affected by heightened risk aversion on the part of international investors after September 2008 and the general deleveraging of financial institutions around the world after the collapse of Lehman Brothers, which led to a sharp drop in cross-border capital flows.

Following a tightening in financing conditions, including the costs of financing,[2] and the significant deterioration in the economic outlook, credit growth plunged in particular in those countries that before the crisis had relied heavily on foreign capital to finance credit booms (i.e. the Baltic States and Romania). This, in turn, may explain the sharp contraction in output in these countries. By contrast, the decline in credit growth was more contained in countries where credit growth had been more subdued and which had relied more on domestic sources of funding before the crisis (see Chart 5). For instance, total credit growth has declined on average by more than 35 percentage points in the Baltic States and Romania between the last quarter of 2008 and the third quarter of 2009, compared with the average growth rates in the pre-crisis period. The reduction in credit growth was smaller for the Czech Republic, Hungary and Poland, at between 5 percentage points and 14 percentage points.

Chart 5 Real GDP and credit to the private sector

(average annual growth rates; percentage points)



Sources: ECB and Eurostat.
Notes: Growth differences from the pre-crisis average represent the difference in average annual growth rates between the period from Q4 2008 to Q3 2009 and the period from Q1 2005 to Q3 2008; average growth rates comprise the period from the fourth quarter of 2008 until the third quarter of 2009.

Credit growth continued to decline in the first quarter of 2010 in all countries but Romania, where it slightly increased. Furthermore, credit growth rates were still negative in the Baltic States and Hungary, ranging between -5% and -7.5%.

Against this background, investment contracted in all CEE countries, although to varying degrees, and contributed in all countries but Poland to the decline in GDP growth (see Chart 6). The sharpest fall in investment was observed in the Baltic States and mainly stemmed from falling investment in the previously booming construction sector, which accounts for half of total investment in these countries. Moreover, cross-country differences in the impact on

2 After September 2008 the cost of financing for non-financial corporations and households increased strongly in most CEE countries. Although interest rates declined somewhat in the second half of 2009, reflecting in particular the lower cost of funding for banks following an expansionary monetary policy in the euro area and many CEE countries, they remained high for loans in domestic currency. However, interest rates on loans denominated in euro declined in most countries compared with their pre-crisis levels.

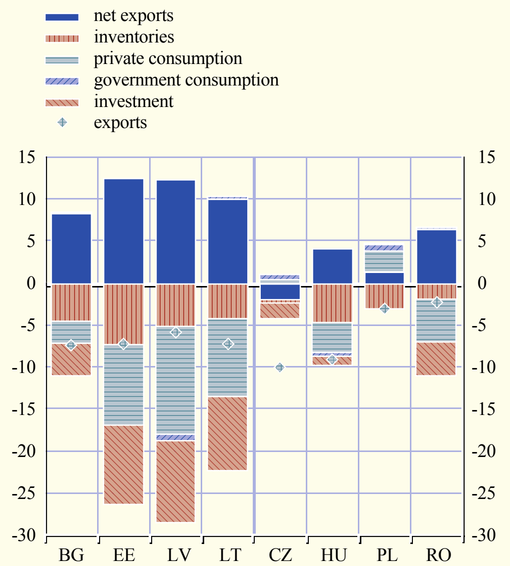
investment may also relate partly to the countries' financing patterns and the degree to which enterprises were dependent on external financing. In the case of Poland, the fact that a large share of investment was typically financed internally may explain why investment was affected less severely.

In all CEE countries, except the Czech Republic and Poland, the sharp drop in domestic demand was also driven by a steep decline in private consumption. The services sector suffered particularly severely from the decline in private consumption and contributed negatively to GDP growth, except in Bulgaria and Poland (see Chart 7). Private consumption contracted very sharply in the Baltic States and Romania. In the case of the Baltic States at least, this may largely reflect the impact of wealth effects – owing to the sharp decline in house and equity prices – and the unwinding of excessive credit-driven private consumption growth before the crisis.

The different paces and degrees to which the labour markets responded to the crisis may also explain the cross-country differences in private consumption developments. Such differences in labour market reactions resulted not only from the extent of the economic downturn in the respective countries, but also from other factors, such as the flexibility of the labour markets (including the effects of employment protection legislation) and employment distribution across sectors. In some countries, in particular the Baltic States with their relatively flexible labour markets, enterprises reacted swiftly to the crisis by cutting wages and dismissing workers, mainly in the construction sector which employed a larger share of temporary workers. In other countries, notably the Czech Republic, Hungary, Poland and Romania, the employment

Chart 6 Expenditure contributions to real GDP growth

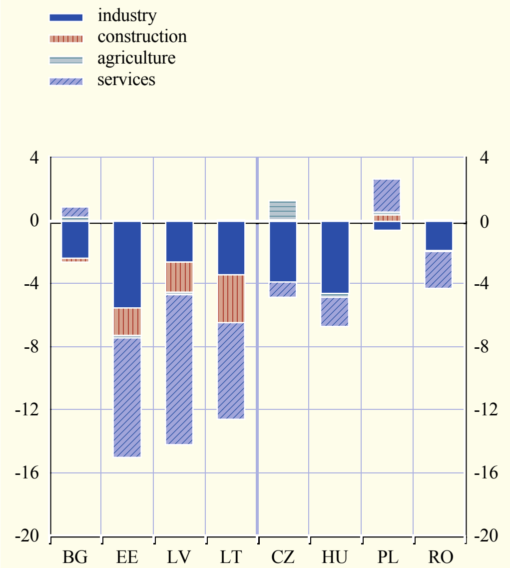
(average annual percentage growth rates Q4 2008-Q3 2009)



Source: Eurostat.
Notes: Data are working day and seasonally adjusted except for Bulgaria (no adjustment) and Romania (only seasonally adjusted). Countries to the left of the centre line have fixed exchange rate regimes or currency board arrangements. Those on the right have more flexible regimes with the central banks pursuing inflation targeting strategies.

Chart 7 Sectoral contributions to value added growth

(average annual percentage growth rates Q4 2008-Q3 2009)



Source: Eurostat.
Notes: Data are working day and seasonally adjusted except for Bulgaria (no adjustment) and Romania (only seasonally adjusted). Countries to the left of the centre line have fixed exchange rate regimes or currency board arrangements. Those on the right have more flexible regimes with the central banks pursuing inflation targeting strategies.

situation remained more robust, partly owing to labour hoarding, with the adjustment taking place to a large extent through lower wage growth and, in the industrial sector, through a downward adjustment of working hours, which was partly facilitated by policy measures.

As a consequence of the sharp decline in domestic demand, and given the high import content of some exports, imports declined sharply in most CEE countries until the third quarter of 2009. In particular in Bulgaria, the Baltic States and Romania the fall in imports far exceeded the notable decline in exports, leading to a positive contribution of net exports to growth over this period in the CEE countries. Only in the Czech Republic did net exports make a negative contribution to growth (see Chart 6).

Table 1 Change in total exports and the nominal and real effective exchange rate

(percentage changes between Q3 2008 and Q3 2009)

	Total exports	NEER	REER-CPI
Bulgaria	-6.7	1.0	1.8
Estonia	-9.6	1.8	0.6
Latvia	-14.7	2.9	3.8
Lithuania	-16.5	2.9	5.1
Czech Republic	-7.7	-4.7	-4.8
Hungary	-6.9	-12.2	-8.0
Poland	-9.0	-20.5	-17.0
Romania	-3.7	-14.4	-10.1

Source: ECB calculations.
Notes: Total exports comprise goods and services and are expressed in constant prices. NEER is the nominal effective exchange rate, REER-CPI is the CPI-deflated real effective exchange rate. A positive (negative) NEER or REER value implies an appreciation (depreciation) over the time period. The first four countries have fixed exchange rate regimes or currency board arrangements, while the last four countries have more flexible regimes with the central banks pursuing inflation targeting strategies.

CROSS-COUNTRY DIFFERENCES IN EXPOSURE TO THE COLLAPSE IN FOREIGN DEMAND

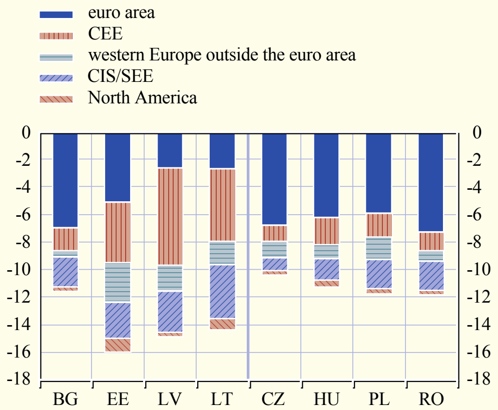
Foreign demand for all CEE countries' exports slumped in the wake of the global financial and economic crisis. Given the high degree of openness of most CEE countries, the trade channel has been important in explaining the impact of the crisis on growth. While all CEE countries recorded a sharp decline in exports between the third quarter of 2008 and the third quarter of 2009, the magnitude of the decline exhibited notable cross-country differences and varied between more than 16% in Lithuania and less than 4% in Romania (see Table 1).

These cross-country differences in the impact on trade can be partly attributed to differences in exchange rate regimes. In fact, countries which saw their nominal or real effective exchange rates weaken sharply between the third quarter of 2008 and the third quarter of 2009, such as Hungary, Poland and Romania, saw a relatively less sharp contraction in their exports. By contrast, the Baltic States, which have fixed exchange rate regimes, saw on average the steepest decline in exports among the CEE countries. Thus, the rather sharp real depreciation may have helped countries with flexible exchange rate regimes to contain the decline in their exports.

Furthermore, cross-country differences in sectoral compositions also seem to explain part of the differing export performances. For a number of CEE countries, the lower external demand for intermediate and capital goods largely affected their exports of cars and automotive parts. One of the main characteristics of the car industry, which is relatively sizeable in the Czech Republic, Hungary, Poland and Romania, is its strong export orientation and, as a consequence, its significant contribution to the export performance of producer countries. As a result of their highly cyclical nature, the car industry and the industries that supply it have been very responsive to the global business cycle. This, in turn, partly accounts for the observed cross-country differences in the impact of the crisis and explains to some extent the negative contribution to growth of the industrial sector in those countries with a sizeable car industry (see Chart 7). Towards the end of 2009 this factor was partly compensated by the positive spillover effects from various car scrappage schemes introduced in other European countries.

Chart 8 Regional breakdown of the contraction in foreign demand

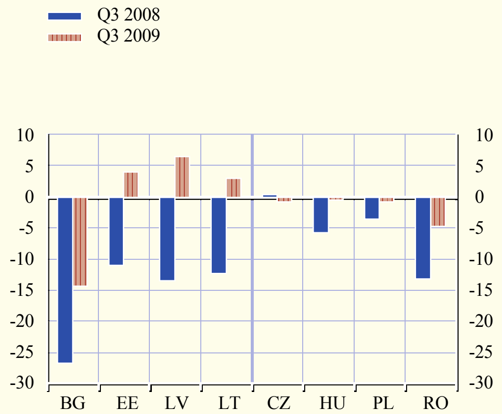
(annual percentage changes in volumes, 2008)



Sources: IMF and ECB calculations.
Notes: Data are only available to 2008. The western Europe outside the euro area aggregate consists of Denmark, Norway, Sweden, Switzerland and the United Kingdom. The Commonwealth of Independent States (CIS) together with south-eastern Europe (SEE) comprises Albania, Azerbaijan, Bosnia, Croatia, Kazakhstan, the former Yugoslav Republic of Macedonia, Moldavia, Mongolia, Russia, Tajikistan, Turkey, Turkmenistan, Ukraine and Uzbekistan. North America comprises the United States of America and Canada. Countries to the left of the centre line have fixed exchange rate regimes or currency board arrangements. Those on the right have more flexible regimes with the central banks pursuing inflation targeting strategies.

Chart 9 Current and capital account balances

(four-quarter averages to Q3 2008 and Q3 2009; as percentages of GDP)



Source: ECB calculations.
Notes: Countries to the left of the centre line have fixed exchange rate regimes or currency board arrangements. Those on the right have more flexible regimes with the central banks pursuing inflation targeting strategies.

The geographical concentration of exports also seems to have played a role in the different trade performances of the CEE countries (see Chart 8). The bulk of CEE countries' exports (ranging from 80% to almost 90% of total exports) are destined for other European countries, a phenomenon that, to a large extent, is related to geographical proximity and the progress made in regional economic integration. However, some cross-country differences prevail. The euro area tends to be the most important export destination for Bulgaria, the Czech Republic, Hungary, Poland and Romania. By contrast, the Baltic States trade heavily with the CEE countries – primarily other Baltic States and Poland – and with the countries in the Commonwealth of Independent States and south-eastern Europe. In particular, the strong linkages among the Baltic States may explain the large negative contribution of the CEE region to the collapse in foreign demand in these countries.

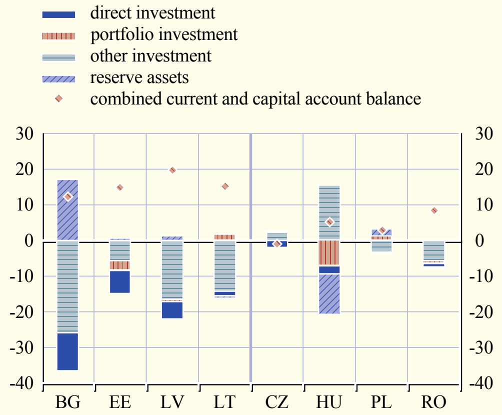
ADJUSTMENTS OF EXTERNAL BALANCES

Mainly as a result of the intensification of the financial crisis, the CEE countries experienced an unwinding of external imbalances. This can be traced back to a substantial decline in domestic demand pressures, leading to a sharp fall in imports, which has more than offset the foreign demand-related contraction in exports. As a consequence, the current and capital account deficits narrowed substantially in all CEE countries except the Czech Republic between the third quarter of 2008 and the third quarter of 2009. At the same time, in the Baltic States the combined current and capital account balances have even turned into surpluses (see Chart 9).

In addition, there have been some notable shifts in the structure of external financing flows (see Chart 10). Since the fourth quarter of 2008 the Baltic States, Bulgaria and Romania in particular have recorded strong net outflows in

Chart 10 Changes in external financing between Q3 2008 and Q3 2009

(percentages of GDP)



Source: ECB calculations.
Notes: The data relate to four quarter averages to Q3 2008 and Q3 2009. Countries to the left of the centre line have fixed exchange rate regimes or currency board arrangements. Those on the right have more flexible regimes with the central banks pursuing inflation targeting strategies.

"other investment", which used to be the prime source of financing before the global financial and economic crisis in some of the countries. The reversal of "other investment" flows can partly be attributed to the reassessment of risks by international financial institutions, the global deleveraging process and the associated transfers of funds by domestic commercial banks to foreign banks, including their parent banks. At the same time, foreign direct investment inflows fell in most countries, although they continued to cover a significant part of the combined current and capital account deficit. Generally, increases in reserve assets are recorded as outflows in the balance of payments statistics. For this reason, net outflows of reserve assets in Bulgaria, which can be traced back to a change in the regulation on reserve requirements by Българска народна банка (Bulgarian National Bank), were recorded as a positive change in the contribution to the financing of the current account deficit. In Hungary a negative change in the contribution to the financing of the current account was related to the disbursements under the country's international financial support programme.

The change in the composition of current account financing appears to have had an impact on the magnitude of overall current and capital account adjustments across countries during the financial crisis. In particular, countries such as the Baltic States which had a large share of "other investment" inflows prior to the crisis experienced a very sharp contraction in their current and capital account deficits.

3 CROSS-COUNTRY DIFFERENCES IN THE POLICY RESPONSE TO THE CRISIS

FISCAL POLICY

Fiscal responses to the crisis differed notably across countries, thereby possibly also contributing to the cross-country differences in the impact of the crisis. The responses reflected the need to balance increasing concerns regarding the sustainability of public finances and other macroeconomic imbalances with the desire to let automatic stabilisers operate or even implement fiscal stimuli to mitigate the detrimental impact of the crisis on economic activity.

In Latvia, Hungary and Romania, the requirements of the IMF and EU financial support programmes imposed strict fiscal consolidation through wide-ranging revenue and expenditure measures from 2009. These measures were targeted at reducing government expenditure by downsizing public administration, lowering public wages, reducing benefit entitlements (e.g. pensions) and reducing capital spending. On the revenue side, measures included inter alia a widening of the tax base.

Bulgaria, Estonia and Lithuania also implemented comprehensive fiscal measures in 2009 aimed at containing the rapid budgetary deterioration. In Estonia and Lithuania, measures comprised in particular cuts in main expenditure items other than social transfers as well as higher taxes. Bulgaria, on the other hand, implemented a number of measures in 2009 aimed at cutting expenditure and raising tax revenue collection

Table 2 Recommendations under the excessive deficit procedures

	Deadline	EU Council recommendation (extract)
Czech Republic	2013	Implement [..] measures in 2010; ensure an average annual fiscal effort of 1% of GDP over [..] 2010-13
Latvia	2012	Ensure an average annual fiscal effort of at least 2.75% of GDP over [..] 2010-12
Lithuania	2012	Implement [..] the corrective measures planned [..] for 2010 [..]; ensure an average annual fiscal effort of at least 2.25% of GDP over [..] 2010-12 [..]
Hungary	2011	Ensure at least a cumulative 0.5% of GDP fiscal effort over 2010-11
Poland	2012	Ensure an average annual fiscal consolidation effort of at least 1.25% of GDP starting in 2010 [..]
Romania	2012	Implement [..] measures in 2010 [..] and continue consolidation in 2011 and 2012; ensure an average annual fiscal effort of at least 1.75% of GDP over [..] 2010-12 [..]

Source: EU Council Opinions.

by improving value added tax and corporate income tax compliance, in order to maintain a sufficiently large fiscal reserve.

In contrast, in the Czech Republic and Poland, fiscal policy was not tightened in 2009 and automatic stabilisers were given room to operate. In Poland the effect of automatic stabilisers was partly offset by cuts in discretionary spending, while some fiscal stimulus measures were implemented in the Czech Republic. In the case of Poland, reductions in labour taxation that had already been approved ahead of the crisis acted as a fiscal stimulus. In the Czech Republic, fiscal consolidation started in 2010 and consisted primarily of measures affecting revenues, such as hikes in value added tax and excise taxes and some cuts in benefit entitlements.

Overall, six of the eight CEE countries are subject to an EU Council decision on the existence of an excessive deficit, and hence their fiscal response to the crisis has also been determined by the recommendations of the respective excessive deficit procedures (see Table 2). In addition, the European Commission has initiated an excessive deficit procedure against Bulgaria, as the country's budget balance reached -3.9% of GDP in 2009.

Generally, an assessment of the appropriateness of the CEE countries' fiscal policy stance during the crisis is particularly difficult in view of the uncertainty surrounding the level and growth rate of their potential output. This complicates an evaluation of the structural efforts underlying the fiscal policy responses to the economic downturn. According to the European Commission, in 2010 only Bulgaria and Estonia are projected to have a deficit below the 3% of GDP reference value set in the Stability and Growth Pact, while the

Table 3 Fiscal developments in the period 2008-11

(percentages of GDP)

	Expenditure ratio		Budget balance				General government gross debt			
		change[1]								
	2010	2008-10	2008	2009	2010	2011	2008	2009	2010	2011
Bulgaria	39.7	2.3	1.8	-3.9	-2.8	-2.2	14.1	14.8	17.4	18.8
Czech Republic	47.0	4.1	-2.7	-5.9	-5.7	-5.7	30.0	35.4	39.8	43.5
Estonia	45.8	5.9	-2.7	-1.7	-2.4	-2.4	4.6	7.2	9.6	12.4
Latvia	44.8	6.2	-4.1	-9.0	-8.6	-9.9	19.5	36.1	48.5	57.3
Lithuania	42.5	5.1	-3.3	-8.9	-8.4	-8.5	15.6	29.3	38.6	45.4
Hungary	48.8	-0.4	-3.8	-4.0	-4.1	-4.0	72.9	78.3	78.9	77.8
Poland	46.0	2.7	-3.7	-7.1	-7.3	-7.0	47.2	51.0	53.9	59.3
Romania	39.9	2.3	-5.4	-8.3	-8.0	-7.4	13.3	23.7	30.5	35.8

Source: European Commission's European economic spring forecast 2010.
1) Changes in the expenditure ratio are expressed in percentage points.

Czech Republic, Latvia, Lithuania, Hungary, Poland and Romania are expected to continue recording large budget deficits. In all CEE countries, other than Hungary, the expenditure-to-GDP ratio is projected to rise significantly in 2010, compared with its level in 2008. Hungary is projected to remain the only country with a debt ratio above 60% of GDP in 2010, while the debt-to-GDP ratios of Poland and Latvia are projected to rise close to this level in 2011. Latvia and Lithuania are also projected to record substantial increases in their debt ratios in 2010, rising to 48.5% of GDP and 38.6% of GDP respectively (see Table 3).

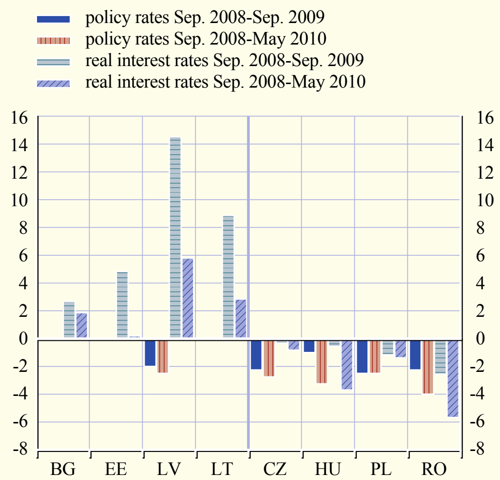
MONETARY POLICY

The conduct of monetary policy – both in the run-up to the crisis and in response to the crisis – differed across countries. This may have also contributed to cross-country differences in terms of the impact of the crisis. As noted above, in the countries where monetary policy was not constrained by the pursuit of an exchange rate target, the reduction in real activity since the outbreak of the crisis has been considerably smaller compared with countries with fixed exchange rates, such as Bulgaria and the three Baltic States. This was partly because of the overheating of the economies with fixed exchange rate regimes in the pre-crisis period, which was driven by strong credit growth fuelled by very low or even negative interest rates. In addition, the countries with fixed exchange rate regimes had very limited scope for autonomous monetary policy responses to the crisis. On the contrary, following the sharp decline in their inflation outlook as a result of the crisis, real short-term interest rates have even increased in these countries, in particular Latvia and Lithuania, compared with their pre-crisis levels, despite the lowering of policy rates by the ECB (see Chart 11). This may have further contributed to the sharp contraction in their GDP growth.

In the countries pursuing inflation targeting strategies, namely the Czech Republic, Hungary, Poland and Romania, the build-up

Chart 11 Changes in policy rates and real short-term interest rates

(percentage points)



Sources: ECB and Consensus Forecast.
Notes: Real interest rates are defined as three-month money market rates deflated by Consensus inflation forecasts for one year ahead. Countries to the left of the centre line have fixed exchange rate regimes or currency board arrangements. Those on the right have more flexible regimes with the central banks pursuing inflation targeting strategies.

of imbalances and the dependence on foreign financing was generally lower in the pre-crisis period, thereby limiting the susceptibility of the economies to a drying-up of external financing. At the same time, the inflation targets seem to have served the countries relatively well as an anchor for inflation expectations. However, in some countries, such as Hungary and Romania, the disinflation process was far from complete in the pre-crisis period, hindered notably by the imprudent conduct of fiscal policy in the past. Overall, the countries with inflation targets were able to engineer large cuts in policy rates in reaction to the crisis.

The pace and extent to which policy rates were cut after the intensification of the crisis differed across countries. In the Czech Republic and Poland, policy rates were cut sharply shortly after September 2008, and the pronounced currency depreciation provided some further support to the economy. In contrast, interest rates were initially increased in Hungary and left unchanged in Romania, before being cut significantly in the course of 2009 and early 2010. In the latter two countries, inflationary pressures remained strong. In addition, exchange rate devaluations posed a major risk to financial stability, given the very high exposure of the private sector to movements in the exchange rate, as a sizeable share of outstanding loans to the private sector was denominated in foreign currency (above 50%).[3] Following the increase in risk aversion on the part of international investors, the central banks of Hungary and Romania had to consider the risks associated with a further depreciation of the exchange rate and subsequent inflationary pressures, as well as the adverse impact on the balance sheets of companies and households. In addition, the fiscal situation in these two countries was particularly difficult, thereby hampering the ability of monetary policy to react to the crisis.

At the same time, the effectiveness of monetary policy was seriously reduced in most CEE countries owing to the global financial crisis, with risk and liquidity premia on the interbank markets generally increasing significantly. The extent to which the crisis impaired the monetary policy transmission mechanism seems to have varied across countries, reflecting the differences between their financial markets in terms of size and liquidity. In view of the impaired transmission mechanism, a number of central banks adopted additional monetary policy measures in order to ease overall monetary conditions and avoid a credit crunch. Some countries also addressed foreign currency liquidity constraints through the establishment of swap facilities with domestic financial institutions.

4 CONCLUDING REMARKS AND OUTLOOK

There are manifold possible explanations for the considerable differences in the impact of the crisis across the CEE countries – and also the varying policy responses to it. The build-up of imbalances prior to the crisis seems to have played an important role in cross-country differences. Countries with the most significant signs of overheating and the most pronounced imbalances were more vulnerable to and generally affected more severely by the crisis. Moreover, the impact of the crisis differed across countries with respect to both the fall in domestic demand and exposure to the collapse in foreign demand. In fact, countries with a high degree of openness, a fixed exchange rate regime and a geographical concentration of exports to other CEE countries and the Commonwealth of Independent States were particularly exposed to the crisis via the foreign demand channel.

Cross-country differences also derived from the different macroeconomic policies pursued across countries before and after the crisis. It appears that the impact of the crisis was particularly pronounced in countries where monetary policy was constrained by an exchange rate target in its response to both overheating pressures prior to the crisis and the subsequent economic downturn. In the absence of sufficiently supportive policies in other areas, such as fiscal policy and regulatory reforms to ensure sustainable credit developments, this contributed to greater output and inflation volatility in these countries. In some countries with inflation targets, a large share of foreign currency denominated debt limited the scope for easing monetary policy in response to the crisis, as exchange rate-related balance sheet effects gave rise to financial stability concerns. Furthermore, in some countries, fiscal policy was not sufficiently tight before the crisis, contributing to overheating pressures and fiscal sustainability concerns. This also limited the scope for fiscal policy to counter the impact of the crisis by, at a minimum, allowing automatic stabilisers to work.

Looking ahead, it is crucial for the CEE countries to avoid the re-emergence of macroeconomic imbalances in the future and to ensure a sustainable convergence process. Countries need to commit to lasting policy adjustments and strengthen the necessary counter-cyclical

3 In Hungary, new regulatory measures came into force in March 2010 to limit the country's high exposure in terms of foreign currency loans to the private sector.

policy tools so that they are in a position to better cope with shocks in an environment where macro-financial linkages seem to play an increasingly prominent role. In particular, given the virtual absence of autonomous monetary policy in countries with tightly pegged exchange rates, it is imperative that other policy areas provide the economy with the wherewithal to cope with shocks and to avoid the recurrence of macroeconomic imbalances.

To allow for a more balanced growth pattern, many countries need to shift resources from the non-tradable sector to the tradable sector. They must also avoid returning to a situation in which the catching-up process is largely driven by excessively strong, externally financed credit growth and asset price increases. Policy adjustments should be geared towards limiting the countries' vulnerabilities, including with respect to foreign currency lending, while at the same time further increasing their capacity to deal with economic shocks, in particular as regards their labour market flexibility.

With respect to fiscal policy, it is important that the CEE countries achieve and maintain sound and sustainable fiscal positions. For many of the countries concerned, having a fiscal surplus is an appropriate objective to limit the risk of boom-bust cycles in the future. Countries that are subject to an excessive deficit procedure must comply with their commitments in a credible and timely manner. Additional mainly expenditure-based consolidation measures are also required in those countries that have yet to attain their medium-term budgetary objectives. Strong fiscal frameworks should also support fiscal consolidation and limit slippages in public expenditure, while helping to prevent a re-emergence of macroeconomic imbalances. With respect to monetary policy, it is crucial for the CEE countries to achieve and maintain price stability on a lasting basis. Once the temporary disinflationary factors related to the economic and financial crisis have abated, this will, in particular, require an overall policy stance which will prevent overheating pressures from re-emerging.