

Glint of hope in eastern Europe

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There is no escaping the difficulties facing central and eastern Europe. The region is heading for its worst recession since the collapse of the Soviet Union, with banks under pressure, investment plunging and unemployment rising fast.

The outlook for the more vulnerable states is terrible. Hungary faces a drop in gross domestic product this year of about 5 per cent, Ukraine up to 10 per cent and Latvia 12 per cent.

But it is wrong to condemn the whole region on the basis of the headline-making and market-breaking worst cases. Amid all the gloom and doom, there are glimmers of hope. First, some countries are faring better than others, notably Poland, where economists still expect growth of perhaps 1 per cent. Low as it is, the number is higher than for any west European country. The only European states with a better 2009 outlook are outposts such as Albania and Azerbaijan.

Next, eastern Europe's economies are already proving to be more flexible than western Europe's in responding to the crisis. While companies are axing jobs almost everywhere, they are going much further in eastern Europe in cutting pay for the remaining staff. Even though wages are much lower than in the west, private employers are making reductions of up to 30 per cent. Governments too are biting the bullet – notably in Latvia, where ministers have taken a 15 per cent hair-cut and are preparing something similar for civil servants. Nobody wants to be treated like this but years of economic turmoil mean east Europeans are better prepared for such shocks than west Europeans.

Also, with less developed economies, east Europeans often enjoy closer family ties than western Europeans, including links with relatives still living on the farm. If the crisis hits poor people hard, in Romania, for example, they can turn to these traditional sources of support – an option that barely exists in western Europe.

Finally, the vexed issue of eastern Europe debt should be kept in perspective. The gross external bank debt of eastern Europe – including Russia, Turkey and Ukraine – of \$1,700bn (€1,295bn, £1,215bn) as reported to the Bank for International Settlements, is huge. But, as Erste Bank says in a recent report, this must be seen in context: in western Europe, the UK alone has gross external bank debts of \$4,500bn.

What matters in assessing potential vulnerability are net positions, where debts are offset against claims against other countries. Erste calculates that on a net basis, the largest borrower, relative to economic size, is Malta, with net bank debts of more than 300 per cent of GDP, followed by Ireland with more than 200 per cent. For Hungary, a country often seen as debt-laden, it is 55 per cent.

Similarly, household and corporate debts are well below west European levels. Total domestic bank assets are 100 per cent of GDP in central Europe compared with 250 per cent in the eurozone. As for public debt, only Hungary comes close to the eurozone average of 70 per cent of GDP. Other east European states are below 50 per cent. Italy, by comparison, is over 100 per cent.

Eastern Europe's problem is servicing these debts in today's markets at a time when recession is likely to generate growing bad loans. On this point, the region is vulnerable. According to the Institute of International Finance, financial flows into emerging Europe (including Russia and Turkey) are set to plummet from \$254bn last year to just \$30bn in 2009. Banks are likely to see a particularly drastic change, from a \$128bn inflow to a \$27bn outflow.

Plugging these gaps requires increased support from the international banks that dominate the region and from multilateral institutions, notably the European Union, the International Monetary Fund, the World Bank and the European Bank for Reconstruction and Development.

But the job is not impossible. The combined GDP of the EU's new member states, the prospective members in the western Balkans and Ukraine is about 10 per cent of the old EU's GDP. Given a bit of breathing space, the region's key competitive advantage – low-cost high-skill labour – will reassert itself. In the short-term, eastern Europe cannot do without western Europe's financial support. But in the long-term, west Europe will need eastern Europe just as much.

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