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"The Global Financial Crisis and its impact on Central Eastern and South Eastern Europe – the cases of Poland, Latvia and Romania"

by

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Abstract

"Pundits, policymakers, and macroeconomists often remind us that banking crises are nothing new, an observation sometimes used to argue that crises are inherent to the business cycle or perhaps human nature itself" (Calomiris, 2009a).

The recent global economic crisis shows how the globalization of the financial system has created a strong interrelationship and interdependence of economies. As a result of this development, a crisis that originally hit a specific part of the credit market, finally affected the world markets, forced the international financial markets to freeze and slowed down the global economic activity. It did not take much time to the economic crisis to spread to Central Eastern and South Eastern European (CESEE) economies where at first it hit the Stock and Capital Markets with a parallel sharp drop on exports and Foreign Direct Investments (FDI). The aim of this study is to identify the main causes of the recent financial crisis and to understand the transmission channels through which it spread to the CESEE region – in particular the economies of Poland, Latvia and Romania, the policies which these countries used in order to cope with the crisis as well as their perspectives, in the new economic and social framework which has been shaped in the European context.

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1. Introduction

The subprime crisis was not just a bad accident. A combination of factors, such as the monetary policy of the FED during the last years and the bubble in the US, regulatory failures, global imbalances and the shadow banking system among others, made the prevention of a global turmoil impossible to avoid. The consequences of the global economic crisis, which spread outward from the US since 2007, have affected economies globally and have changed the global financial picture. Starting with the collapse of the subprime mortgage market and mortgage – backed securities, it expanded to the bond and interbank markets, leading to the disruption of the normal operation of the global financial system. Not only did banking systems experience serious difficulties, but public debt crises also arose and currencies came under pressure. The countdown started in June 2006, when the FED decided to increase the interest rates and it worsened after September 2008, with the collapse of the investment banking firm Lehman Brothers. Since then, the financial systems throughout the world have experienced the domino – effects of the crisis. The global economy came into a deep downturn, affecting the real and financial sectors, in both advanced and developing countries.

The contagion spread, via different channels, around the whole world. It had at first been thought that the CESEE - new EU member states would not be affected by the spreading financial turmoil as their financial institutions were not involved in the financial transactions of risky assets, characteristic of the US and some Western banks. Chronic dependence on external financing and a high level of economic and trade integration with the EU were the underlying reasons why CESEE countries suddenly found themselves deeply affected. They were hit hard within a short time due to a series of factors that highlighted how previous high growth became unsustainable once the external environment took a turn for the worse (Galgoczi, 2009).

Results, however, have not been homogenous in the region. The Baltic States – the previously stated as the "Baltic tigers"- were hit first and then the rest of the countries in the region started to experience the results of the crisis in late 2008. The extent of the contagion differs and this is obvious in the following chapters. The volume of capital flows, especially FDIs and the level of trade dependence on the rest of the EU partners, as well as the choice of exchange rate regimes and the structural characteristics of their economies, seem to be the main reasons that explain both why the region was hit and the extent to which each country was affected. Asset prices were hit, banking sectors were shaken, listing an important increase

in non – performing loans, unemployment rose, public debt increased and government deficit widened in most of these economies.

The different ways by which these countries were affected also leads to different policy choices in dealing with the crisis. Domestic policies and the intervention by the IMF, the EU and the World Bank included, among others, restrictive fiscal policies, tax increases, cuts in wages, currency devaluations, in order to regain stability and improve the economies' competitiveness. IMF intervention under various forms in some of these countries – although debatable- helped calm markets in the short- term.

Growth outlook is expected to be bleaker in the following years, not only because of the structural weaknesses of the CESEE economies and the necessary fiscal consolidation but also due to the developments in the euro area. Despite the recent coordinated support, the european environment remains fragile. High interconnectedness with the euro area makes CESEE countries susceptible to shocks and determines their growth prospects to a large extent.

The purpose of this study is to identify the main reasons which led to the crisis, to analyze how it spread to the CESEE region and how it affected the economies of Poland, Latvia and Romania, their policies towards the crisis, the new European context under the Eurozone debt crisis and the perspectives of these countries for the future.

2. The Global Financial Crisis

2.1 Definition of the crisis

Financial crises can be defined in many ways and take many forms as every crisis is different and involves its own distinctive elements. Summers (2000) defines international financial crisis as a situation where the international dimension substantially worsens a crisis in ways that would not occur in a closed economy. By using this definition, Summers does not try to understate the major role of domestic fundamental weaknesses but rather to exclude situations where it is primarily poor domestic economic performance that leads to debt – servicing problems. According to Mishkin (1992), a financial crisis is defined as a disruption to financial markets, in which adverse selection and moral hazard problems become much worse, so that financial markets are unable to efficiently channel funds to those who have the most productive investment opportunities. This results in the inability of financial markets to function efficiently, which leads to a sharp contraction in economic activity. This disruption originally occurs in one country and then diffuses to other countries as well. According to Summers (2000), the contagion of a crisis from one country to another can be transmitted through the following mechanisms:

- Due to common shocks (like terms of primary commodity price shocks).
- Trade linkages.
- Competitive devaluations among countries may explain excessive currency depreciations.
- Financial linkages lead to asset - market correlations, thus poor economic performance in one country also affects countries which have lent to or invested in this country.
- Market illiquidity, which can lead countries to reduce their positions in other markets, thus feeding contagion.
- Investors' irrationality, such as panic and herding, which leads to indiscriminate withdrawal from many markets, without taking into account each market's fundamentals.
- "Reputational externalities". A crisis in one country can affect investors' expectations and perceptions about common structural conditions and vulnerabilities in other countries and the likely policy response to such vulnerabilities.

With these mechanisms at work, a disruption in one economy can rapidly be transmitted to other economies as well. Depending on the tension of the linkages between countries and the weightiness of the causes of the crisis on their economies, the crisis can even become global, as is the case which we will focus on.

2.2. Causes and results

The causes of the crisis have been subject to considerable debate and the consistent history of the events which followed the collapse of Lehman Brothers in September 2008 has led to excessive analysis. Nevertheless, all the attempts which have tried to explain the crisis center on the triggering role of the housing bubble in the US. There seems to be a broad agreement that factors as financial innovation in the form of asset securitization, government policies to increase homeownership, global imbalances, expansionary monetary policy and weak regulatory oversight played an important role for the escalation of the crisis. In this chapter, we will attempt to explain the main causes of the crisis.

2.2.1. Causes of the crisis

2.2.1.1. Monetary Policy Errors

The period of the Great Moderation was characterized by a high degree of macroeconomic stability and steady growth and many Central Banks in the developed countries adopted inflation targeting policies. Low and stable inflation had the consequence of keeping interest rates also at low levels, thus borrowing by individuals became more affordable and this led to significant rise in house prices as well as to a rapid increase in households' indebtedness.

During the years before the crisis, the prices in the real estate sector in the US were increasing steadily, leading to the prospect of homeownership as a good investment. The Fed's monetary policy and low interest rates had a significant impact on the housing market in the US, since the Fed kept pursuing loose monetary policy (following the burst of the dot – com bubble) and at the same time expressed its willingness to step in to provide liquidity in case the

financial markets had problems, the so-called—Greenspan put[1]. These assurances and a range of housing policies discussed below, led to increasing lending significantly, even with loose criteria to creditors who were barely creditworthy. The Fed deviated sharply from the ‘‘Taylor Rule’’ in setting interest rates during 2002–2005; the Federal funds rates remained substantially and persistently below levels that would have been consistent with that rule (Calomiris, 2009a) . Credit became too cheap, leading to a situation of excess liquidity which supported an incipient housing boom since 2002.

2.2.1.2. Housing Policy Errors

Housing policy errors encouraged households to over – borrow during the boom. ““Every American deserves to own a home”. The US government promoted this policy and expanded it even to low – income households, with loose criteria (the so-called NINJA loans, No Income, No Job, No Assets), thus leading to excessive borrowing and to a large increase in the subprime mortgage lending (Calomiris, 2009a) as well as to creating more exotic types of mortgages to allow lower credit quality – borrowers to afford loans. The increased availability of mortgages led to a departure of the housing prices from fundamentals. Also, the government backing of the two mortgage giants, Fanny Mae and Freddie Mac (with the motto of “We make home possible”) was a key tool to promote lending to subprime borrowers, by investing in high – risk subprime mortgages. The two large lenders decided to increase their investments in subprime mortgages and related securities, by buying and selling mortgages in secondary markets, and ended up holding a considerable amount of exposures to toxic mortgages.

2.2.1.3. Securitization and the shadow banking system

Since the mid – 1980s, advancements in technology, financial innovations and more sophisticated investors have combined to make asset securitization one of the fastest growing activities in the capital markets. Securitization evolved rapidly to a major funding source within few years. Although securitization can be used as a valuable tool with the purpose of repackaging and selling assets to investors better able to manage them thus bringing great economic benefits and improving the overall efficiency of financial intermediation, the way it

[1] The Greenspan put created a belief that the government would bail out traders that needed to be rescued after a bubble had burst, but not intervene to stop it from rising, since it was not possible to know a priori whether a bubble existed and it was therefore only possible to intervene ex post.

was handled during the run – up to the crisis, combined with the above mentioned housing policies and the fact that the terms for providing loans had relaxed, led to a widespread misuse of securitization with the main goal to achieve higher and higher yields.

The decline in the profit – making opportunities of traditional commercial banks that faced competition from other financial institutions further encouraged non – transparency and partly resulted in the growth of the shadow banking system (Lin, Treichel, 2012). Besides, the increase in demand for debt was not matched by an increase in bank deposits, thus banks had to find funds elsewhere. The capital adequacy requirements set forth by the Basel Committee on Banking Regulation obliged banks to hold a higher level of capital for loans granted to high – risk borrowers. On the other side, low interest rates made investors search for new opportunities which could offer higher yield. The process of securitization (or even re-securitization) became a convenient tool in order to serve these interests. The shift by banks towards the so-called "originate-to-distribute" business model (which as argued by Parlour and Plantin (2008), diminishes banks' screening and monitoring incentives) of extending loans and then distributing much of the underlying credit risk to end-investors led to a dramatic growth in the market for credit risk transfer (CRT) instruments(Crouhy, et al., 2008). Through securitization, banks could free up their balance sheets, allowing them to pool and tranche a bundle of loans and either sell the tranches to outside investors or put them in off - balance sheet vehicles. By removing loans from their books, underwriters of CDOs could decrease the capital charges imposed by the Basel Accords and their own internal risk requirements and thereby free up cash to make new loans. Thus, banks could improve their existing capital ratios by transferring credit risk away from their balance-sheets. Apart from the simplest mortgage – backed securities (MBSs), through which investors received returns from an underlying pool of mortgages, including both prime and subprime loans, this market also included more complicated resecuritized instruments and derivatives like credit default swaps (CDSs), a sort of insurance contract on the risk of holding mortgage loans. Initially, it seemed that everyone was benefiting. But, as the collateral composition of CDOs changed, in favor of aggressive search for higher yields, the market became more and more unable to control their composition, since in many cases these products were so complex that the actual risk associated with them was not known until massive defaults did occur. Finally, these instruments spread the risk of mortgage defaults throughout the global economy.

2.2.1.4. Failures in Regulation

The prudential regulation of commercial and investment banks has proven to be ineffective and this reflects fundamental problems in measuring bank risk, resulting from regulation's ill-considered reliance on inaccurate rules, credit rating agencies' assessments and internal bank models to measure risk , as well as the "too-big-to-fail" problem, which makes it difficult to credibly enforce effective regulatory discipline on large, complex financial institutions, even if regulators detect large risks (Calomiris, 2009a). The prospect of their failing is considered so potentially disruptive that regulators have an incentive to avoid intervention. That ex post ''forbearance'' makes it hard to ensure compliance ex ante. Banks with access to deposit insurance and Central Bank support tend to pursue higher – risk activities, thus endangering the soundness of the financial system as a whole. Besides, the US Commodity Futures Modernization Act of 2000 ensured that derivatives, unlike stocks, bonds and options, remained unregulated.

2.2.1.5. Global Imbalances

The discussion about global imbalances - the large current account deficits and surpluses resulting in capital flows from capital – poor emerging market countries to capital – rich industrial economies (especially the US) – as one of the causes of the crisis, is strongly debated. One hypothesis is that it came from a global saving glut, as the saving rate in emerging markets rose. Another hypothesis is that it arose from the decline of investment opportunities worldwide. A third proposition was the desire of fast – growing emerging countries for international diversification and low – risk liquid assets. And, fourth, emerging markets (especially China) accumulated foreign exchange reserves to fight the appreciation of their currencies and support export competitiveness (BIS, 2009). A large proportion of the current account surpluses were invested in developed countries. The increased demand resulted in higher prices and lower government bond yields and low returns on fixed income financial assets across all advanced economies. Nevertheless, Lin and Treichel (2012) support that global imbalances were the result of excess demand in the US, resulting from the public debt which arose from the Afghanistan and Iraqi wars and tax cuts and the overconsumption by households, rather than economic policies of East Asian countries.

2.2.1.6. The role of the Rating Agencies

The fact that a significant part of the transactions had been moved off – balance sheet affected the ability of the rating agencies in addressing the vulnerabilities of the banking system. Besides, the role of the rating agencies in providing third – party evaluation of the likelihood that a borrower will repay a loan or bond was influenced by manipulated incentives, mainly due to their dependence on the financial institutions for employment and future contracts. As C. Calomiris (2009b) supports, there is evidence that buy – side investors further encouraged the debasement of the rating process though the process of "rating shopping". Before sponsors requested a rating, they asked rating agencies to hypothetically tell them how much AAA debt they would allow to be issued against a given pool of securities being put into a portfolio. If a rating agency was conservative to its answer, the sponsor would use another agency. As a result, excessive risk-taking was not recognized by rating agencies, effectively encouraging even riskier behavior.

The above factors are by many analysts supported as the main causes which caused the burst of the crisis. Moreover, excessive risk-taking was also encouraged by a variety of moral hazard problems. For instance, the bonus – driven incentives for employees in the financial institutions, which largely depended on whether the returns generated by the investment exceeded those of a risk-appropriate benchmark. Investment banks found that such returns were more likely if the investment was associated with tail risk that means with an event that was very unlikely to occur. However, it is in the nature of a tail risk event that the likelihood of it occurring increases exponentially when more and more individuals undertake actions that are based on the assumption that it will not occur (Lin and Treichel, 2012).

2.2.2. Results of the crisis

FED's decision to raise interest rates in 2006, mainly as a result of the increase in the price of oil and the US increasing inflation rate, marked the countdown for the outburst of the crisis. House prices started to decline in 2006, causing loan delinquencies and foreclosures to rise sharply since borrowers were no longer able to refinance. In its World Economic Outlook of April 2006, the IMF pointed out that house prices were looking more richly valued and buyers had increasingly resorted to interest – only and negative amortization loans to gain access to the market, indicating that the housing market was cooling. Falling house prices and tightening credit availability took a toll on consumption. Investors started to realize that the credit ratings of structured credit securities were more likely to suffer more rapid and severe downgrades than corporate bonds. This was a particular problem for banks, since many of them did not have the expertise to analyze the risks of asset – backed exposures and relied on rating agency analysis for due diligence. When these securities began to be downgraded in July 2007, banks incurred significant losses.

The collapse of the two hedge funds of Bear Sterns and later the announcement by the French Bank BNP Paribas in August 2007 that it was suspending withdrawals from some money market funds, caused wide interbank market turmoil. Money market funds defensively shifted their portfolios to overnight and ultrashort maturities. This provoked the collapse in the market for ABCP (the short-term paper that was being used to fund off-balance-sheet investments in long-term assets) and made it difficult for banks to borrow for longer than overnight. In early 2008 the UK's Northern Rock required emergency funding from the Bank of England and the near – collapse of Bear Sterns in March 2008, exposed the fragility of trust in wholesale markets and put additional pressure on bank capital. Six months later, Lehman Brothers suffered a similar fate as Bear Sterns but this time without a government bailout. Lehman filed for Chapter 11 in September 2008, mainly as a result of accumulating defaults on mortgages and derivative products, causing markets to freeze and further shaking confidence in the financial systems (the post – Lehman era). Counterparty risk caused a dramatic liquidity squeeze in the global financial system. Besides, the bankruptcy of Lehman Brothers also accelerated the nationalization of AIG, the biggest insurance company worldwide. Merrill Lynch was sold to Bank of America whereas Goldman Sachs and Morgan Stanley, the last two remaining independent investment banks, were converted to bank holding company status. Thus, although the crisis originated in the housing market, it spread to the financial and later to the real sectors as well.

Thus, the explosion of the crisis led to the interruption of the operation of the interbank and corporate bond markets with a direct consequence the involvement of financial institutions which were not highly leveraged. It became obvious that the dimensions of the crisis were going to be global. Furthermore, both in the US as well as in Europe, after September 2008, there were massive bank runs. Many governments, such as Ireland, decided to intervene by granting guarantees covering their banks' liabilities in order to rescue them, since most of them faced problems of liquidity or capital adequacy. In many cases this led to nationalization.

The escalation of the crisis also led to its transmission to the emerging markets and developing economies, which in general seemed not to have been affected until the third semester of 2008. Investors started to abandon massively these countries, thus the spreads of government bonds increased substantially at the end of 2008. Stock markets crashed. As for Central Eastern and South Eastern Europe, many countries, such as Hungary, Romania and Ukraine, among others, had to turn to rescue packages from the IMF. The consequences for the countries of Central Eastern and South Eastern Europe have not been homogeneous. Neither their response to the crisis. These will be examined in the next chapters.

3. The effects of the crisis in the CESEE region

The countries of the CESEE region share many common characteristics, the main of them being political and historical. The great social and political changes after 1989 in the region, have led to the transition from central planning towards democracy and market economy. Advances in the economical and business sectors have boosted privatization and soon after 1989 the whole region created financial and trade linkages with the European Community/ Union. Nevertheless, these developments differ from one country to another. They joined the EU in 2004, except from Romania and Bulgaria which became members in 2007.

Although they are parts of the same region, they can also be divided in the following categories: the Baltic states (Estonia, Latvia and Lithuania), the Central Eastern European states (Poland, Hungary, the Czech Republic, Slovakia, Slovenia and Croatia), whereas Bulgaria and Romania are geographically more Southern European states.

In this study, we will concentrate on the consequences of the global financial crisis on Latvia, Poland and Romania and their response to the crisis. This choice represents the sub-regions mentioned above. Whereas these countries share a common history which for years separated them from the rest of Europe and they are often perceived as a whole, their vulnerabilities towards the crisis were not similar.

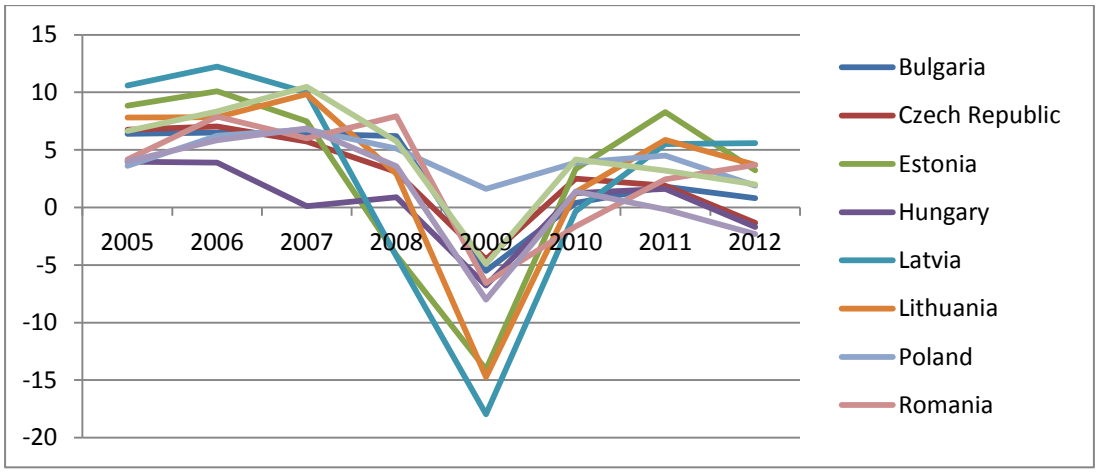
3.1. The CESEE region profile prior to the crisis

After 1989, when the CESEE region emerged after a number of years of relative isolation, but especially during the years 2000 - 2007, the economies of Central Eastern and South Eastern Europe experienced large capital inflows from the West which triggered expansions in consumption and investments. The transition to market economies resulted in a rapid and complete openness to trade and foreign capital. These developments led to a credit boom—with banks extending loans to households and firms on an unprecedented scale. The CESEE countries were good examples of emerging economies which imported large amounts of capital to finance their growth and convergence process. Most economies experienced robust, export – led growth while economic and financial integration with the advanced economies proceeded. The prospect of EU accession required the implementation of significant legal and institutional reforms and spurred further trade and financial integration with the EU (Gardo and Martin, 2010). Subsequently, integration made most CESEE countries more depended on

exports. The more and more integrated financial sectors also became more dependent on the advanced economies, as a source of investment opportunities (ECB, 2010, p. 85 – 96).

Until the third quarter of 2008, the CESEE region was remarkably resilient to the global financial crisis. This is partly due to the fact that the region had no or only negligible exposures to subprime or subprime-related assets. Towards the end of 2007, it was being suggested that these economies would "decouple" from the US (BIS, 2008). The crisis hit the region, starting with the Baltic States, in the beginning of 2008, and the rest of the economies in the third quarter of 2008, with full force. This can be reflected in a sharp decline in their GDP growth (Graph 3.1).The global financial crisis affected the CESEE region through various channels of transmission. In fact, CESEE countries were hit hard via the indirect financial transmission channels. Foreign investor confidence towards emerging markets quickly dashed hopes of a possible decoupling of the CESEE region from the global turmoil. Economic activity contracted rapidly, exports slowed down, industrial production declined and domestic credit growth began to weaken. Developments have, however, not been homogenous in the region.

Graph 3.1: GDP growth rate



Source: Data from the World Bank

Table 3.1: GDP growth rate

	2005	2006	2007	2008	2009	2010	2011	2012	2013p	2014p
Latvia	10,6	12,23	9,97	-4,24	-17,95	-0,34	5,47	5,6	4,2	4,2
Poland	3,62	6,23	6,78	5,12	1,62	3,89	4,34	1,9	1,3	2,2
Romania	4,17	7,89	6	7,92	-6,57	-1,64	2,45	3,7	1,6	2

Source: Data from the World Bank and IMF

3.1.1. Poland

Among the 10 states that joined the EU in 2004, Poland was the largest with nearly 40 million inhabitants. A member of the former Eastern bloc countries, Poland faced significant challenges in its way towards EU membership, relating to public sector financing, transparency, infrastructure, social and economic policy, unemployment.

When Poland joined the EU, its situation started to improve, with growing investment mainly from the EU investment funds, and the country experienced high growth prior to the crisis. State interference in the economy needed to be reduced so privatization moved at a quick pace whereas further progress in transport and energy infrastructure were key structural reform challenges in order to reap the efficiency gains of restructuring and further potential growth.

Its relatively large and diversified domestic economy, its limited external imbalances in the years prior to the crisis, solid banking regulation and supervision and relatively moderate credit growth strengthened the resilience of the Polish economy to the global financial crisis. In fact, Poland was the only EU economy to avoid recession in 2009.

3.1.2. Latvia

Latvia was forcibly incorporated into the Soviet Union in 1940 and gained independence in September 1991. The collapse of the Soviet Union was welcomed by the Latvian people who had not voluntarily joined that state. Latvia's determination to become an EU member led to the "Europe Agreement" in 1995 and to its full membership in May, 2004. Latvia experienced a banking crisis in 1995, which led 15 banks go bankrupt and impeded economic growth but the harsh resolution cleansed the Latvian banking system. The Latvian economy took off in 1997 but especially after the Russian financial crisis (1998), the country turned upward and it began to experience high economic growth and was one of the fastest growing new Member States. In particular, the country accomplished double – digit economic growth between 2005 – 2007, which can be attributed to its measures to attract foreign capital (e.g. reduction in corporate income tax).

It was in end - 2006 that the economy began to show signs of overheating, as illustrated by rising wages, increasing inflation, combined with a fixed exchange rate to the euro and a widening current account deficit. Rapid credit growth, a property - price boom and short – term capital inflows, largely from foreign banks, and expansionary bank lending were also the characteristics of the years before the crisis. Besides, banking sectors of the Baltic states were

characterized by a dynamic credit growth, with a very high share of foreign currency loans and linked with a real estate market bubble. Slowdown in lending started in mid – 2007, driven by concerns among foreign banks about their overexposure to the Baltics (IMF Country Report No. 09/3, 2009).

The country stands out as the East European country hardest hit by the global financial crisis. In 2009, Latvia's GDP growth rate was reduced by 17.95%, registering the highest decrease in the region.

3.1.3. Romania

Romania, the 7th largest country of the EU, based on the number of inhabitants, became an EU member in 2007, after a rather difficult transition. Romania has the lowest GDP per capita in the EU, along with Bulgaria. Nevertheless, its growth rate during 2001 – 2007 was approximately 6% annually whereas in 2008, GDP growth of the Romanian economy was 7.9% which has located Romania in the 1st place in EU-27 for 2008. Thus, the country saw a period of explosive economic growth, which resulted in an upward trend of public revenue and expenditure, however this did not materialize in budget deficit reductions, which increased from - 1,2% in 2004 to -9% in 2009 (Table 5.3), but rather was oriented towards consumption.

Macroeconomic imbalances, which were reflected in high increases in private – sector foreign – currency debt and large current account deficits, high social spending, unsustainable economic growth until 2008, based mainly on the consumption of imported goods financed by foreign money, double – digit growth rates in public sector wages without being accompanied by a significant increase in public sector efficiency and widespread legislative instability, are the characteristics of the years before the crisis. On such unstable ground, the emergence of the crisis entrained consistently negative effects and made Romania more vulnerable to the consequences of the global economic environment.

3.2. The stages of the crisis in the CESEE region

The crisis can be regarded as unfolding in four stages:

Until September 2008

With the exception of the Baltic States, where extreme credit booms peaked, the crisis left the CESEE region almost unaffected during its first three quarters, as capital inflows generally held up, credit growth continued and domestic demand remained buoyant (EBRD Transition Report 2009). This can be attributed to the fact that the crisis originated in the US mortgage market and other asset markets, to which CESEE countries were not directly exposed.

October 2008 - March 2009

The crisis hit in the fourth quarter of 2008, after the turmoil that followed the collapse of Lehman Brothers, which caused a liquidity shock. The notion that banks were "too big to fail" was no longer available. Within a month, the threat of a domino effect through the global financial system forced western governments to inject vast sums of capital into their banks to prevent them from collapsing. The Eurozone officially enters recession. Stock markets collapse. Consumer and business confidence collapse and credit flows to the private sector come to a halt. Although in the CESEE region there were cross – country differences, bank lending flows, FDI flows (Graph 3.5) and export volumes (Graphs 3.6, 3.7) declined significantly between the years 2008 – 2009. In a region highly dependent on foreign markets, it did not take long for these contractions to translate into severe hardship (Berglof, 2009).

April 2009 – October 2009

In line with the general recovery in international financial markets, regional financial indicators began to point upwards beginning in April 2009. Industrial output declines either slowed or reversed in a number of countries and confidence indicators stabilized. Asset prices recovered from the previous lows. At the same time, ripple effects of the real shocks began to be felt in the corporate, household and banking sectors, with gradual rises in unemployment (Graph 5.1), corporate insolvencies and non-performing loans (Table 3.2) (EBRD Transition Report 2009). Across the CESEE region, industrial production and construction fell fast and, accordingly, these sectors have shed the greatest number of workers. National governments scrambled to cope with the crisis and to reignite the economic dynamism that defined the region over the past decade.

November 2009 -

High debt levels, serious and persistent budget deficits and low economic growth contributed to the sovereign debt crisis, in particular in the euro area periphery, which later spread to the core of the euro area, shading confidence in the European financial system. Markets for short and long-term funding became increasingly impaired in 2011, with the range of available funding instruments falling and the cost of funding rising. The interbank market largely dried up. The ECB and other central banks took action to maintain bank liquidity and facilitate refinancing. EU banks reduced their exposure to the CESEE economies. Cross – border outflows started to occur. With banks' funding problems turning increasingly severe in 2011, new concerns emerged about credit outflows from CESEE and the consequences this would have for the real economy. In 2011, various EU banks announced reductions in credit volumes.

3.3. The Transmission Channels

Although there are as many transmission channels as there exist “windows” from one country to the world economy, the following chapter intends to explore the main transmission mechanisms for the contagion of the economic crisis to the CESEE economies.

3.3.1. Direct Channel – The toxic assets

The CESEE region was largely resilient to the toxic asset problem, with negligible local banks’ exposure. This can be attributed to the fact that the CESEE financial sectors still exhibit a low degree of sophistication and penetration in complex financial products. The exposure to sub-prime mortgages and related “toxic” assets such as collateralized debt obligations (CDOs) and structured investment vehicles (SIVs), does not appear to have been significant in CESEE countries (OECD, 2011, p.11 - 32). Also, banking sectors in the region are dominated by foreign banks – mainly West European banks - with parent banks’ exposure to subprime-related assets appearing to be manageable in most cases or by absorbing the costs by transferring them to their country. This can explain the fact that, until the third quarter of 2008, the region did not appear to be affected by the financial crisis.

3.3.2. Indirect Channels

Consequently, the direct channel did not have a significant impact on CESEE economies. But then, how did the crisis manage to affect the CESEE region? In fact, CESEE markets were hit hard via the indirect financial transmission channels. The collapse of Lehman Brothers, which caused the freezing of the financial markets, in conjunction with the deterioration of development prospects of the global economy, led to investors' unwillingness to undertake any kind of investment risk. This resulted in a slowdown of capital inflows into the region and pressure on asset prices, with a direct influence on the cost of financing and growth rates, although developments have diverged significantly within the region (Gardo and Martin, 2010). Besides, indirect channels can be connected with what is called "country risk".

3.3.2.1. Asset Prices

After the mid- 2008, stock and real estate prices were severely hit. However, there are cross – country differences which can be attributed to certain political, economic and social aspects, which affect investors' confidence.

Stock prices were hit first, nevertheless the percentage of stock market capitalization to GDP in 2007 was still at low levels for CESEE compared to the EU , mainly because of the further need for development of institutional infrastructure and regulatory mechanisms (Caporale et al., 2009), so the effects of this channel lasted for a relatively short period.

WIG in Poland fell at about 46.30% in the period between September 2008 – February 2009[2].

Graph 3.2: Poland - Stock Market (WIG)

Source: Warsaw Stock Exchange

OMX Riga in Latvia fell at about 57.50% during the same period[3].

Graph 3.3: Latvia - Stock Market (OMXR)

Source: Riga Stock Exchange

[2] Available at:
http://www.gpw.pl/indeksy_gieldowe_en?isin=PL9999999599&ph_tresc_glowna_start=show

[3]Available at: http://www.nasdaqomxbaltic.com/market/?lang=en

BET Index in Romania fell at about 51% during the period September 2008 – February 2009[4].

Graph 3.4: Romania - Stock Market (BET)

Source: Bucharest Stock Exchange

Real estate prices in most CESEE countries developed very dynamically during the last years before the crisis, due to various reasons:

- Fast rise in disposable income.
- Increased demand for housing by foreign investors.
- Enhanced availability and affordability of mortgages.
- Favorable tax treatment of housing loans which contributed to stronger estate demand and higher house prices.

After the burst of the crisis and the deterioration in financing conditions alongside with the decreasing demand from foreign investors, real estate prices fell considerably. This development also led to an increasing share of problematic loans and a low demand in the construction sector, which until then was an important driver of growth in many CESEE countries.

In Poland, prudent loan–to-value (LTV) ratios helped limit household sector vulnerabilities from foreign exchange denominated mortgages.

[4] Available at: http://www.bvb.ro/

In Latvia, real estate prices jumped more than 60% in 2005 and 2006 (IMF Country Report, No. 09/3, 2009). In the summer of 2007, SEB started tightening its credit policies towards Latvia and a few months later so did Swedbank, putting an end to the peak of the credit boom, initially hitting the household and construction sectors. Real estate prices plunged by 70% in two years from a sharp peak in 2007 until early 2009. The real estate sector came to occupy nearly half of all total loans, since banks in Latvia offered mortgage loans very easily and many of them with loan to value ratios above 100% (IMF Country Report No. 06/354, 2006) . Until then, the real estate sector was the 2nd largest share in FDI, after financial intermediation.

In Romania, the main threat was the high share of foreign currency loans in total loans, since asset prices are published in euros and mortgage loans are mainly in euros. Besides, foreign-owned banks' access to the cheap resources in the international markets was easier.

3.3.2.2. Exposure to Exchange Rate Volatility

The Central and Eastern European countries represent a wide range of exchange rate regimes, from currency boards to flexible exchange rates. All free- floating CESEE currencies came under intensified market pressure in end-2008. Exchange rate pressures prompted many Central Banks to intervene.

The role of exchange rate regimes seems to have been critical in the way that it determined the country's ability to counteract the effects of capital inflows, as there were differences in the size of the internal and external imbalances between fixed and floating exchange rate countries. Indeed, countries adopting a fixed exchange regime (Latvia, in our case) experienced in general more pronounced credit booms, higher inflation rates and larger account deficits than the average for floating exchanges regime countries. The flexible exchange rate regimes somehow seem to have shielded the countries to some extent from the crisis by currency devaluations. Yet, the assessment of the contribution of the exchange rate regime remains an open issue, as it is unclear to what extent this can be explained by the fixed exchange regime or by the overall policy mix (Visco, 2013). Besides, the flexible exchange rate regime, despite the fact that it has the advantage of competitiveness, it becomes more sensitive in imported inflation due to devaluation.

An important driver of this channel pertains to foreign currency borrowing and foreign indebtedness: Foreign debts remain more often than not uncovered against exchange rate risks: with exchange rates devaluating in the course of the crisis (unexpected at the time of borrowing), debt burdens increase beyond the planned extent and make borrowers more vulnerable to default. (Stephan and Brezinski, 2010). Besides, excessive use of external wholesale funding by the domestic banks can accelerate credit growth well above the rate of GDP growth, which may create a growing credit risk within the banking system. Furthermore, increased foreign currency lending may raise banking sector' s vulnerability to international financial market tensions as banks use foreign financing and FX swaps to close the gap between foreign currency loans and deposits. Finally, foreign currency lending may also pose challenges to monetary policy making, to the extent of the influence that interest rates and exchange rate policies exert on the demand for foreign currency debt (Belka, 2011).

The Polish government started to sell EU funds directly on the foreign exchange market to support the zloty. It was one of the CESEE currencies hardest hit. It lost about 46% of its value between August 2008 – February 2009.

Latvian government's starting point, when laying down the anti-crisis measures, was that devaluation was unthinkable. The Prime Minister, Godmanis, had clarified that devaluation was out of the question, putting an end to the scenarios that the IMF had required from the Bank of Latvia to reduce the exchange rate of the lat. Given the high share of foreign currency borrowing, depreciation would have immediately damaged household and corporate balance sheets, leading to increased private sector defaults, collapse in domestic demand and a deeper initial recession (the private sector had a net external debt of 70% GDP in late 2008). Instead, Godmanis pursued internal devaluation by introducing large cuts in public expenditures and state salaries as well as smaller ones in the private sector. This policy also leads to the above - mentioned balance sheet effects but the process takes place over time, allowing banks to adjust. Perhaps the strongest argument against depreciation was the risk that it would encourage speculative attacks against other European countries with pegs (IMF Country Report No. 10/ 356, 2010).

The Romanian leu lost around 25% for the same period (Stephan and Brezinski, 2010) causing foreign currency borrowing, (two-thirds of total loans were euro – denominated) to become dearer.

3.3.2.3. Capital Flows – Foreign Direct Investment

Amongst the most obvious transfer channels is the drying up of capital inflows. CESEE economies have been affected extremely via the tightening of global credit conditions, resulting in a slowdown of capital inflows into the region. During 2008 - 2009, in most CESEE countries, capital inflows dropped considerably (Graph 3.5). In most of the region, growth and modernization were largely driven by FDIs. FDI is an important source of financing for transition economies, since it helps cover the current account deficits, facilitates transfer of technology, know – how and skills and plays an important role in the process of convergence.

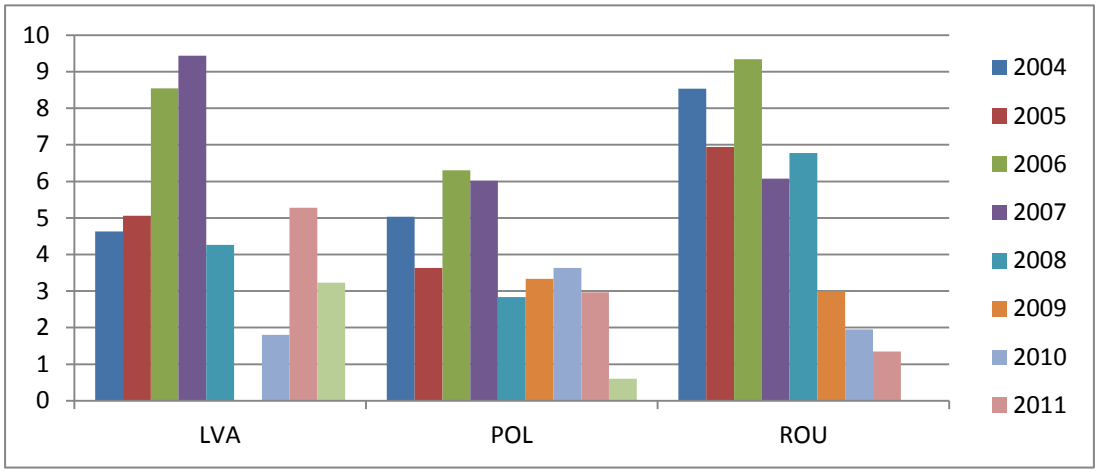
FDI inflows in Poland fell during the crisis, but rather modestly, remaining at higher levels than in other countries of the region. In 2009, the decline was less than in comparator countries. Amid the surrounding economic turmoil, Poland was perceived by investors as an island of stability (Z. Zimny, 2010). Having had since years high standards of entry, treatment and protection of foreign investors, Poland focused its efforts on improving the general investment climate for all investors. As of June 1, 2009, Poland had 59 Bilateral Investment Treaties (one of them with the US, since 1990). The majority of funds targeted the manufacturing sector, financial services and the real estate sector. However, some bureaucratic and regulatory hurdles, coupled with poor transportation infrastructure explain why Poland does not perform so impressively when the size of FDI is related to the size of the country.

In Latvia, FDI during the years before the crisis partly covered the huge amount of its trade deficit. More than 60% of total FDI inflows in 2008 were in the real estate sector, valued at around US$ 2 billion. In 2009, there was just one investment in this sector, amounting to US $100 million (PwC, 2010).

Romania, as Latvia, covered its trade deficits through FDI. According to the Romanian National Bank's statistics, in 2009 the investments were backing the current account deficit at a rate of 96,8%. Many important foreign companies (e.g. Unilever, Kraft Foods and Coca Cola) relocated their Romanian subsidiaries in cheaper workforce countries such as Moldavia and Bulgaria, despite Romania's skilled and adaptable labor force, while only a few new companies decided to invest in Romania (for instance, PepsiAmericas). A negative effect of FDIs in Romania comes from their strong unbalanced distribution among the regions, with the Bucharest-Ilfov region concentrating 63%.

With no doubt, FDI has been a necessary modernization lever, which has helped CESEE economies achieve higher levels of growth and convergence with their western European neighbors. Nevertheless, on the other hand, this resulted in a dependent economic position. This factor most probably adds to their vulnerability under stormy conditions.

Graph 3.5: Foreign Direct Investment, net inflows (% GDP)



Source: Data from the World Bank

3.3.2.4. The Banking Sector

CESEE banking sectors were fairly resilient to the global economic and financial crisis until autumn 2008. In the third quarter of 2008, however, a number of supply and demand-side factors negatively affected bank lending throughout the region. These factors included the increasingly tight global liquidity conditions, banks' increased risk aversion and falling credit demand against the background of strongly decelerating investment and consumption growth (Galdo and Martin, 2010). Increased credit risks and the related higher need for provisioning started to put a strain on banking sector profitability. Furthermore, the share of non-performing loans to total loans started to increase in all CESEE countries in the second half of 2008 and increased further in 2009, mainly as a result of falling GDP, rising unemployment and weaker national currencies. Western banks' financial difficulties (Austria, Germany, and Italy -as well as Sweden in the case of Latvia - account for the largest share of foreign claims for CESEE countries as a whole) led them reduce their positions vis-à-vis CESEE – mainly from Romania and the Baltic states- in order to meet their liquidity needs (Stephan and Brezinski, 2010).

Nevertheless, it seems that, the entry of foreign intermediaries with long-term strategic goals and the transformation of the ownership structure of banking systems in CESEE countries, after their privatization, was a crucial element of discipline and stability in breaking the vicious cycle of banking crises and macroeconomic volatility that had characterized the early years of transition. Moreover, the distinctive model of financial integration in the CESEE region – where foreign banks operate mainly through their local subsidiaries and branches in the retail market – probably provided a high degree of risk sharing and stability during the crisis, as parent banks were generally less sensitive to information asymmetry and counterparty credit risk and more committed to long-term market prospects (Visco, 2013).

Poland's financial sector, although affected by, showed a relative resilience to global recession. Poland's banking strategies were generally conservative, especially towards purchasing speculative instruments, since privatization in this country started relatively late and banks performed traditional roles of commercial banks. Commissions and fees from basic banking operations offered satisfactory profits, thus riskier and more sophisticated products were avoided. Besides, prior to the crisis, the Polish banking system was dominated by foreign banks (foreign ownership accounted for about 72% of the sector's assets in 2009), mainly from EU countries, which granted decisive assistance and shielded Poland's financial system. Foreign banks continued to view their Polish investments as strategic, to share know-how and improve infrastructure, thus expressing their long term commitment in the region (Strojwas, 2010). Although NPLs have increased since the onset of the crisis, they remain at moderate levels (Table 3.2). Recommendation S, which was introduced in 2006, helped discourage FX lending. The negative effects of this channel came by through risk management, particularly the terms of banking policy towards credit for corporate clients, since foreign banks limited their credits for Polish firms more than Polish banks did. Moreover, the financial sector was affected by capital outflows and rising interbank interest rates, reduced liquidity and a rapid depreciation of the Polish zloty (EBRD Transition Report 2009).

In Latvia, most of the loans were denominated in euros. This allowed foreign banks – which owned 60% of the banking system - a ratio which was smaller than in Estonia and Lithuania- to lend large amounts without having an open foreign currency position. Borrowers were induced to borrow in euros by a lower interest rate and, with the exchange rate peg there did not seem to be much exchange risk. Given these incentives, there was a plausible argument that any policy to constrain domestic bank lending would simply have led to disintermediation and direct borrowing from foreign banks. Indirect foreign currency exposure and maturity transformation by banks and a consequent fear of floating led to

crippling balance sheet losses (Bakker and Lipschitz, 2011). Nevertheless, the parent banks of foreign banks introduced financial support schemes to boost confidence. Credit to the private sector was at almost 90% in 2007 (almost double when compared to 2004) and the ratio of NPLs/ total loans reached 14,3 in 2009 and 15,9 in 2010 (Table 3.2).

Due to the general financial environment as well as due to management mistakes, Parex Bank, Latvia's second largest bank and largest independent commercial bank, collapsed in November 2008. It could no longer finance itself on the European wholesale market and it had syndicated loans falling due. Facing a run, it lost one – quarter of its deposits during August – November 2008. On November 8, the Latvian government announced that it was buying 51% of Parex (for the symbolic amount of 2 lats). Yet, the outflow of deposits did not stop and on December, 1 the authorities imposed a partial freeze on deposit withdrawals. The government had to recapitalize Parex at a total of 4.9% GDP. On December, 5 the government increased its share of Parex to 85%, as required by the IMF, in order to appoint new professional management to run the bank (IMF Country Report No. 09/3, 2009). Besides, from the end of August until the end of November 2008, total bank deposits declined by 10%. As usual late in their assessments, the three rating agencies down-grated Latvia in the fourth quarter of 2008.

Romania's banking sector has been dominated by foreign banks from Austria, Greece and France. Whereas, previously, commercial banks had been competing for market share in Romania, after the crisis they were trying to accentuate the deleveraging process, so as to reduce vulnerabilities. The resulting uncertainties about future fiscal policy and concerns about the magnitude of the current account deficit led the international rating agencies to cut Romanian credit ratings drastically. Driven by the weak economic environment along with high provisioning requirements and credit risk intensification, the rising in non – performing loans (Graph 3.2), given also the rapid growth of foreign exchange denominated loans in the years prior to the crisis, there were serious concerns about how the banking system would cope as the domestic currency depreciated, nevertheless, Romania had tried to ensure capital adequacy even before the outburst of the crisis (Popa, 2011) and the capitalization of the banking sector remained at relatively good levels.

Table 3.2: Non – performing loans to total loans

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Latvia	1,1	0,7	0,5	0,8	2,1	14,3	15,9	13,9	11
Poland	14,9	11	7,4	5,2	4,4	7,9	8,8	8,2	8,4
Romania	8,1	2,6	1,8	2,6	2,8	7,9	11,9	14,3	16,8

Source: Data from the World Bank

3.3.2.5. Impact on the Real Economy - The Trade Channel

Economic developments in the CESEE region were also affected via the real channels of transmission, in particular the trade channel, since the CESEE countries relied heavily on exports to Western Europe, whose demand was weakened. Except for the Baltic States, in most CESEE economies the crisis had hardly any visible impact on the real economy until the third quarter of 2008, when the foreign trade channel was activated by a slump in global demand, triggering a slowdown in economic growth in all CESEE countries. Continuing this way until the second quarter of 2009, most CESEE economies saw a mild recovery in the latter part of 2009 (Graphs 3.6, 3.7).

The trade channel appears to have been amongst the most prominent real transmission channels of the crisis for most CESEE economies**.** This is not surprising, given the region's increasing trade deepening and rising trade integration with the EU in the last two decades. The once again country – specific differences depended on the countries' trade openness and trade specialization as well as to differences in exchange rate regimes. In fact, countries with floating exchange rate regimes saw a relatively less sharp contraction in contrast to countries like the Baltic states, with a fixed exchange rate regime (Stephan and Brezinski, 2010). Thus, the real appreciation may have helped countries with flexible exchange rate regimes to contain the decline in their exports.

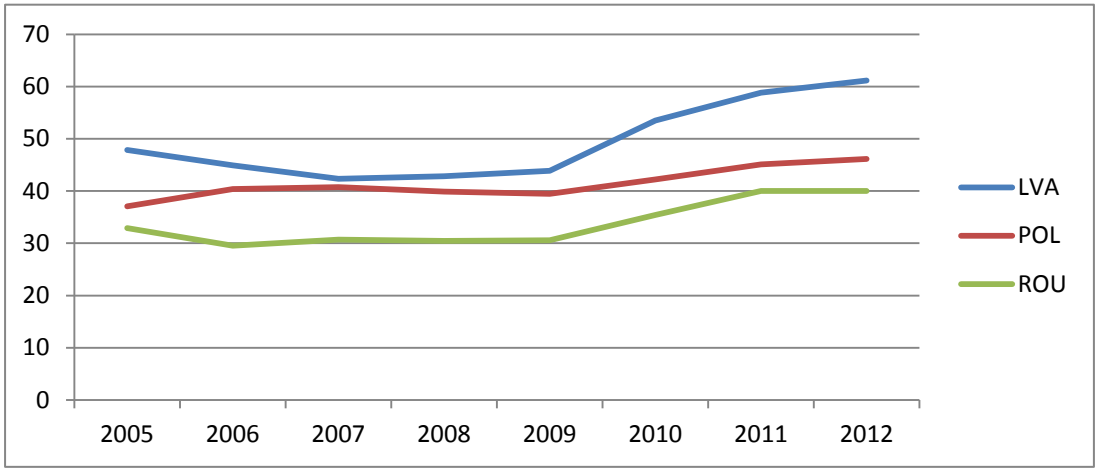
At the same time, imports collapsed due to a slump in domestic demand. However, with imports falling more quickly than exports, the contribution of net exports to GDP growth soon turned positive in most countries. The slump in domestic demand in CESEE was caused by worsening labor market conditions and income prospects, deteriorating business and consumer confidence, and tighter credit conditions.

The recession does no t seem to have strongly affected Poland in regard to the decrease in demand for Polish products (such as machinery, minerals, metals, chemicals). Considering that its European neighbors are Poland's largest trading partners there was a natural decline in Polish exports. Nevertheless, Poland's domestic economy is large, with exports playing a much smaller role. Besides, the floating exchange rate and depreciation of the Polish zloty helped contain exports. Also, lower labor costs and higher labor market flexibility helped to maintain growth in industrial output and exports. Moreover, the Polish economy is heavily tied to Germany, the largest economy in the EU.

Increasing wages that surpassed productivity and inflation gradually eroded Latvia's export competitiveness. In this small and open economy, recovery can be governed by exports and not by domestic demand. Every year the country recorded a huge amount of trade deficit, partly covered by FDI inflow. In 2005, the current account deficit was at 12.4% GDP, which was already an alarming amount, and it rapidly increased to 22.7% GDP in 2006.

The deep recession led to a decline in Romanian exports, nevertheless the current account deficit melted down to 4.23% GDP in 2009 from 13.63% GDP in 2007 (Table 5.2). This development was not the result of specific policies addressing it, but rather was due to the diminished internal demand which caused imports to decline even steeper than exports, thus narrowing the trade deficit. Exports entered positive territory in the fourth quarter of 2009. Since early 2010 export growth, and in particular manufacturing exports including machinery and equipment, have been booming and constitute the main factor contributing to aggregate demand. With a minimum wage of around 160 euros per month, Romania has a major comparative advantage in labor costs over other countries in the European Union. (International Labor Office, 2011).

Graph 3.6: Exports of goods and services (% GDP)



Source: Data from the World Bank

Graph 3.7: Exports of goods and services (annual percentage growth)

Source: Data from the World Bank

4. The Challenges for the European Union and the Eurozone

4.1. From the Global Financial Crisis to the Eurozone Debt Crisis

The global financial crisis that started as a subprime crisis spilling from the US in 2007, became more complex and reached new dimensions in 2009 and led Europe into a deep recession. The nature of the crisis has changed fundamentally. What started as a banking crisis has transformed into a sovereign debt crisis in the eurozone. Concerns about the sustainability and potential restructuring of public finances created new tensions in the financial markets. Both the recession and the adoption of fiscal stimulus packages to counteract it resulted in a ballooning of fiscal deficits and a massive deterioration of debt indicators that set the stage for the sovereign debt crisis in the eurozone and threatened the foundations of European monetary integration.

The global slowdown in growth heightened vulnerabilities that had already been in place before the crisis (Lin and Treichel, 2012). Notably, countries that had their own housing booms, like Ireland and Iceland, or had high fiscal deficits before the crisis, like Greece and Portugal, now teetered on the brink of a sovereign debt crisis and required support from the ECB and the IMF.

Financial market players seemed to ignore the growing risk until 2010. The dominant view - that the major eurozone powers, first of all Germany, somehow underwrite the debts of the weaker members – soon collapsed once it became obvious that such a guarantee does not exist and, despite the creation of the European Financial Stability Facility (replaced in 2012 by the European Stability Mechanism) aimed at supporting the countries in trouble, the financial credibility and ratings of the Southern European eurozone members started dropping dramatically, while the interest rates on their debt radically increased. Bank recapitalization took place with direct (capital injections) or indirect (guarantees, asset relief) public aid. The debt crisis in the Southern part of Europe and the austerity measures which were implemented led to a dramatic deterioration of the business sentiment throughout Europe. Both the deteriorating financial situation in the Southern part of the eurozone as well as the widespread recession in the EU, have had an impact on CESEE countries, through their economic and financial ties mainly with Western Europe (PwC, 2012).

The outlook for growth in the region worsened and risks to its continuation increased significantly due to the persisting financial market volatility in the eurozone. The currency area, as mentioned before, is a significant export market for the CESEE economies and an

important source of FDI. Eurozone-based banks represent large shares of banking systems in emerging Europe. Their troubles at home mean cutting back on lending in the region. The ability of the countries of the region to deal with this threat crucially depends on the strengths and weaknesses of their respective economies since within the region the outlook is mixed.

4.2. Towards a European Banking Union?

The gap between institutional integration and financial integration can lead to a number of complications which can threaten financial stability. Institutional integration should approximate the actual level of financial integration as closely as possible (EBRD Transition

2012). A "banking union" which would create an ECB-led single supervisor directly addressing recapitalization of banks using funds from the European Stability Mechanism (ESM) is a key component for making the eurozone more stable.

Due to the development of the financial and sovereign debt turmoil, a set of supervisory institutions has been established since 2011. The European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority, the European Securities and Markets Authority, the European Systemic Risk Board (ESRB) - with the purpose to achieve better coordination and information sharing, to oversee the application of EU regulations and to arbitrate between national supervisors. However, the exercise of financial supervision and resolution of failed banks remains mainly under national control. The European Stability Mechanism (ESM), which was established in September 2012 and which replaced the EFSF and the EFSM, is designed to safeguard financial stability in the euro area by providing financial assistance to euro area member states experiencing or threatened by financial difficulties.

In March 2013, the European Council committed to complete the Banking Union via the following steps. First, the completion of the legislative procedures for the Single Supervisory Mechanism (SSM) conferring powers on the ECB to supervise Euro Area banks. Second, agreement on how the European Stability Mechanism (ESM) could recapitalize banks directly. Third, agreement on the Commission's proposals for a Directive of establishing a framework for the recovery and resolution of credit institutions and investment firms. Finally, the Commission's proposal for a Single Resolution Mechanism (SRM) should be examined as a matter of priority. When established, the Banking Union will cover all Euro Area Member States and those non-Euro Area Member States that choose to join.

In July 2013, the Commission proposed the Single Resolution Mechanism for the eurozone, which, once in operational in late 2014, gives the authority to the ECB to directly supervise banks in the euro area and in other Member States which decide to join the Banking Union. The purpose is to deliver decisions quickly and efficiently, avoiding uncoordinated action, to manage banking crises more effectively as well as to replace national resolution funds of the euro area member states with contributions from the banking sector (shareholders and creditors), thus limiting the effects on taxpayers. The resolution of a bank is subject to the Commission's decision, acting in the interest of the Union as a whole. The European Council has called on the Council to agree on a position by the end of the year (EC Proposal, 10.7.2013[5]).

There are some main reasons why Europe is committing itself to a banking union.

- Dealing with existing bank weaknesses that contribute to the euro crisis.
- Reducing the risk that banking will contribute to later stages of the euro crisis.
- Restoring the effectiveness of the monetary policy of the ECB.
- Reintegrating the European banking system.
- Fixing long-standing problems with the "single market" in banking in the EU (Elliott, 2012)

Nevertheless, there are concerns on the side of host countries of eurozone banks that do not expect to join the banking union anytime soon. Among them is a worry that supervisory coordination failures, which marred attempts to control national credit booms before the crisis, will persist when eurozone home supervisors are replaced by a single, powerful home supervisor – the ECB. Another fear is that the banking union would tilt the competitive balance inside the European Union against banks headquartered outside the banking union, as the latter would not be covered by the fiscal safety net provided to banking union members.

[5] http://europa.eu/rapid/press-release_IP-13-674_en.htm

5. Response to the crisis

The countries of the CESEE region, as previously mentioned, have been hardly hit by the global financial crisis and they had to respond with extensive reforms. In this chapter, we are going to refer to the main actions undertaken by the CESEE – 3 as a response to the crisis.

5.1. Poland

When reflecting upon Poland in relation to the crisis, one is often reminded of the famous presentation by the Prime Minister, Donald Tusk, at the end of January 2010. During the presentation, the Prime Minister stood in front of a giant map of Europe. Each EU country was red, with indicators displaying the percentage of loss in its respective GDP. The lone "green island" in this sea of red, was Poland – with a positive increase of GDP. In 2009, while most of the EU was wallowing in a recession, the GDP of Poland actually grew by 1.62%. This might be attributable to a lower degree of export dependence**,** a strong (albeit partly temporary) fall in the exchange rate (which notably contained imports), the strong fiscal stimulus financed partly through EU structural funds, limited imbalances at the onset of the crisis, a relatively unleveraged banking system and proper monetary policy responses. Following strong economic growth of more than 4% in 2011, GDP growth slowed to 1.9**%** in 2012 (Table 3.1) and further decelerated in early 2013 (1.1% in 2013Q2[6]), as renewed turmoil in the Euro zone weakened business' and consumers' confidence, leading to a drop in investment and stagnation in private consumption.

The crisis resulted in uncertainty in the Polish financial market and a decline in confidence among the interbank market participants. In immediate response to the crisis, the government released the "Stability and Development Plan - Strengthening the Polish economy in the time of the World Financial Crisis" on November 30, 2008. The plan called for action and legislation in activities to stimulate investment in the Polish economy and to maintain the stability of the financial system, by including guarantees for deposits, inter-bank loans, and the creation of a Financial Stability Committee, and also by implementing a "Trust Package" by the National Bank of Poland to increase the liquidity of the banking system (Reichard, 2011). The National Bank of Poland implemented anti-crisis measures such as 1) mitigating economic downturn for workers and entrepreneurs, 2) providing assistance in the repayment

[6] Source: ECB, Monthly Bulletin, 9/2013.

of housing loans to people who lost their jobs, 3) supporting medium and large enterprises, by implementing projects important for the Polish economy (Eurofound).

The so-called "Confidence Pact" by the Central Bank, was announced in mid-October 2008. In the framework of measures connected with the "Confidence Pact," the Central Bank started conducting repo operations providing liquidity to the banking sector. Swap arrangements with other Central Banks, including the Swiss National Bank and the European Central Bank, helped to calm fears over banks' foreign exchange liquidity, even if the scale of transactions was relatively low (NBP Report, 2009). Besides, the quality of the foreign currency mortgage loans remained relatively stable despite the zloty's significant depreciation, which suggests that the tighter lending standards imposed by Recommendation S (which induced more restrictive creditworthiness assessment for foreign currency loans) in 2006 had been helpful in limiting credit risk.

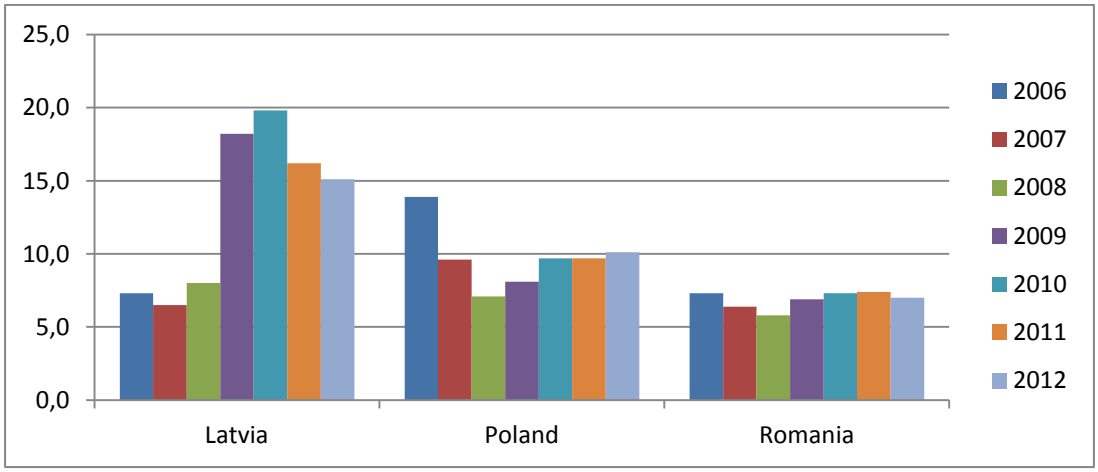
Reforms aimed at improving the Polish economy's competitiveness in the medium-term include enhancing the business environment by raising the retirement age (from 60 to 67 by 2040 for women and from 65 to 67 by 2020 for men) and by promoting innovation and modernizing public administration. Sources of income for the government are the proceeds from privatization by reducing the share of state ownership in the economy. Privatization is recognized as a means to bring down its deficit and as an alternative to raising taxes. Between 2008 and 2011 the government completed the sale of 562 companies, which brought an income of around 10.3 billion euros. The government has made attempts to reform public services, such as health and education, that take up a significant share of its overall spending. It has proposed a series of laws, including one that would allow public hospitals to be turned into commercial companies. The government attempts to instigate a similar process of commercialization and liberalization of education (Rae, 2012).

Poland is also benefiting from large amounts of resources from the EU structural and cohesion funds. Poland is the main beneficiary of these funds with €68.7 billion in the current financing period (2007-2013). The approval of a 6- month IMF credit line of $20.6 billion in May 2009 for Poland —the Flexible Credit Line, for which countries with strong economic fundamentals and policy track records can apply, when faced with balance of payments pressures— was granted with the intention to act as a precautionary measure to strengthen investor confidence in Poland's capacity to access foreign funding and this helped calm markets. Nevertheless, the latest two-year extension to $33.8 billion granted in January 2013, has indicated the slowdown of the Polish economy during the last months. As Julie Kozack[7],

[7] http://www.imf.org/external/pubs/ft/survey/so/2013/car011813a.htm

IMF mission chief for Poland, explains, both external and domestic factors have triggered the slowdown. These factors include the low demand for Poland's exports, a rise in non-performing loans, rising unemployment and tighter credit which affect domestic consumption and, mainly, the developments in the euro area. The rising of government spending– particularly through increased public investment – has meant that Polish society has been sheltered from some of the worst effects of the crisis. The combination of tax cuts and high public investment helped in supporting domestic demand and maintaining a respectable GDP growth rate, however, this policy has led to an increase in public debt and high deficits. Government deficit increased from -1,9 in 2007 to -7,4 in 2009 (Table 5.3).

Graph 5.1:Unemployment rate (% total labor workforce)



Source: Eurostat

Table 5.1: Central Government Gross Debt and Projections (%GDP)

	2011	2012	2013f	2014f
Latvia	37.47	36.42	41.00	36.66
Poland	56.39	55.17	56.83	56.23
Romania	34.24	37.04	36.88	36.60

Source: IMF

5.2. Latvia

Until 2007 Latvia's debt level was one of the lowest among EU member states but the high budget deficit and the attraction of international funding led to a rapid increase in the country's public debt. Central government debt rose sharply from 22.8%to 49.8% GDP from 2008 until 2010. External debt dominated in the state debt structure. Cheap and easily available loans also increased private sector debt. The labor market witnessed a sharp decline in demand as economic activity contracted. This entailed significant growth in unemployment (Graph 5.1), which more than doubled within a year, from 7.4% in 2008 to 17.1% in 2009. Economic competitiveness had already decreased since 2007, mainly as a result of rising wages and inflation. The Central Bank's decision to raise the refinancing rate by 50 bps to 5%, which was still lower than the inflation rate (but could not act otherwise due to pegging) – thus, the interest rate was practically negative – proved quite insufficient to dampen the overheating economy. In 2008, Latvia posted an annual inflation of 17.5%, its highest level since 1996 (Graph 5.2.).

Latvia had to require an emergency program from the IMF (IMF Stand –By Arrangement) - supplemented by financing from the EU, the World Bank and several Nordic countries – of € 7.5 billion in late 2008 (to be disbursed over three years) in order to stabilize its economy, which required a substantial tightening of fiscal policy as a means to reduce financing needs and improve competitiveness (IMF Survey Magazine, 2009). Thus, on December 11, 2008 the Ministry of Finance published "Latvia's Economic Stabilization and Growth Revival Program" and the government implemented a restrictive fiscal policy and substantial fiscal consolidation, primarily severe public expenditure cuts and some tax increases, with the purpose of ensuring financial sustainability. Latvia did not devalue, although it ran a big current account deficit (Table 5.2). Instead, it pursued internal devaluation, cutting wages and public expenditures. The average public wage was cut by 26% whereas in the private sector the reduction was smaller. A moderate increase took place in 2011. Fiscal consolidation in Latvia, and in the Baltic states in general, was among the most severe in Europe. VAT was raised from 18% to 22%, as the IMF demanded.

Also, the Latvian government targeted three sectors for far – reaching structural reforms: public administration, health care and education. Administrative reforms included the closure of 75 state agencies, which also meant a considerable amount of civil servants dismissal. The government decided also to close more than a half of the country's hospitals and the situation was similar in education. All allowances were reduced (childbirth, paternal, child care) for about 35% - 40% (Dovladbekova, 2012).

Although the measures were difficult and led to austerity, they were necessary to prevent an excessive budget deficit and to establish conditions for economic growth, with the support from the Central Bank of Latvia. Indeed, Latvia's economic situation is becoming more stable, with GDP reaching 5,5% and 5,6% in 2011 and 2012 respectively, thanks to gradually restoring domestic demand. Productive investments in manufacturing and transport help foster the economy. Exports increase steadily since mid – 2009 (Graphs 3.6, 3.7) and the current account balance turned positive in 2009 (Table 5.2), which can be attributed partly to an increase in exports to dynamic markets such as Germany and Sweden and partly due to a fall in imports which underlines the severity of the adjustment of the economy. The target of a fiscal deficit of no more than 8.5% in 2010 and 6% in 2011 that the IMF Program had posed, was met by the Latvian government (Table 5.3). Rates of returns of foreign direct investment have risen, thus highlighting opportunities for larger FDI inflows, although competition with other Baltic countries is very tough. A substantial amount of inflows ended up in the real estate and financial sectors. FDI in 2012 declined as global FDI did, mainly due to continued macroeconomic fragility and policy uncertainty for investors (UNCTAD, 2013). FDI is an important tool in order to ensure that productivity convergence occurs, in this small country with a low saving level.

Table 5.2: Current account balance (%GDP)

	2005	2006	2007	2008	2009	2010	2011	2012	2013f	2014f
Latvia	-12,42	-22,68	-22,33	-13,34	8,82	3,01	-2,2	-1,67	-1,8	-1,9
Poland	-2,38	-3,85	-6,23	-6,6	-3,98	-5,11	-4,85	-3,54	-3,6	-3,5
Romania	-8,59	-10,42	-13,63	-11,6	-4,23	-4,41	-4,39	- 4,0	-4,2	-4,5

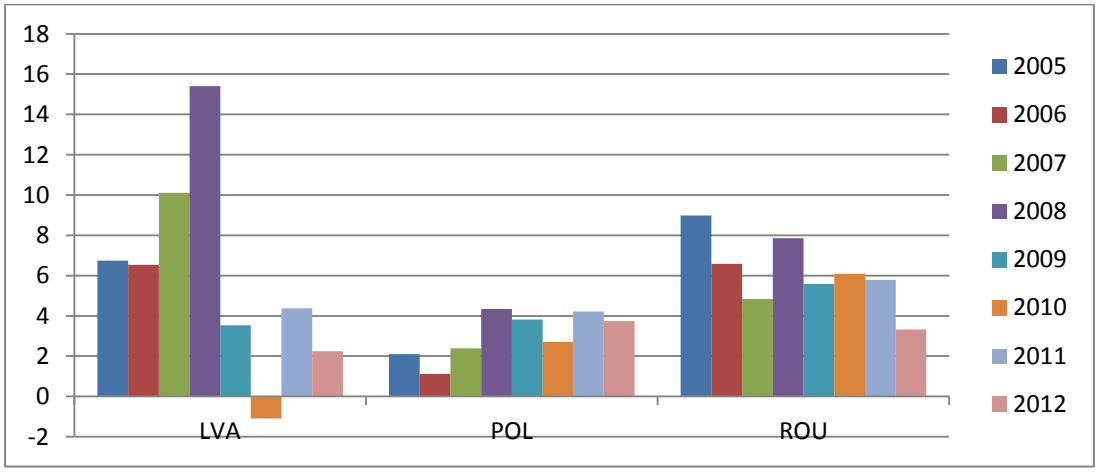
Source: IMF

Table 5.3: Government budget balance (%GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Latvia	-1,6	-1	-0,4	-0,5	-0,4	-4,2	-9,8	-8,1	-3,6	-1,2
Poland	-6,2	-5,4	-4,1	-3,6	-1,9	-3,7	-7,4	-7,9	-5	-3,9
Romania	-1,5	-1,2	-1,2	-2,2	-2,9	-5,7	-9	-6,8	-5,6	-2,9

Source: Eurostat

Graph 5.2: Inflation (%annual)



Source: Data from the World Bank

5.3. Romania

Since late 2008, Romania has had to cope with persistent economic difficulties. It experienced a reduction in FDI (Graph 3.5), which had in the past period been one of the most essential factors determining economic growth in the country. Romania is a country with a long history of excessive current account deficits (Table 5.2) resulting from low domestic savings rates that do not match investment needs. GDP growth rate reduced from 7,9% in 2008 to -6,5% in 2009 (Table 3.1).

In early 2009 the Romanian authorities began to negotiate a Stand-By Arrangement with the IMF (the country had also resorted to IMF's SBA in the past), which was approved for a 24 – month period in the amount of €12.95 billion. The government had already commenced the process of fiscal retrenchment in late 2008. This included a 3 percentage point reduction in the fiscal deficit brought about by increases in social contributions, indirect taxes hikes and public wage bill cuts introduced in the 2009 budget. As a result of the deteriorated economic outlook, the IMF review mission in May 2010 agreed to raise the budget deficit target in 2010 to 6.8 per cent of GDP. To achieve even this revised target, the package included a 25% cut in public wages, the elimination of holiday bonuses and the 13th month salary in the public sector, a 15% reduction in most social transfers and a 5 percentage point jump in VAT. The Central Bank's aim was also to target inflation. The government also announced in February 2009 the launch of a €13 billion stimulus package to help the country through the global

economic crisis. Some €10.2 billion, were to be spent on investments, mainly in infrastructure. Important reforms were also implemented to the pension system, increasing retirement ages and altering pension indexation arrangement (International Labor Office, 2011). A 24-month Stand-By Arrangement equivalent to €3.5 billion was granted again in March, 2011. Additional funds for the Fund-supported program were provided by the European Union (€1.4 billion) and the World Bank (€1.0 billion), on a precautionary basis.

Despite an increase in the ration of NPLs, the banking system successfully weathered the worst effects of the economic crisis. The Vienna Initiative proved successful in Romania; parent banks provided additional capital to banks throughout 2009-10 and the capital adequacy ratio of all subsidiaries remained above 10%. In June 2010 the government approved a bill proposed by the antitrust and consumer protection body, ANPC, to eliminate fees applying to early repayment or termination of bank loans with interest rates linked to money market indicators (EBRD Transition Report, 2010).

6. Risks and perspectives

There is a possibility that risk perception will stay higher in the region in the following years because of budgetary problems, gloomy export perspectives and overall increased uncertainty in the eurozone. Thus, capital inflows will be lower and domestic credit conditions tighter. It will take time to restore the international competitiveness of most of the CESEE economies, especially those with fixed exchange rates, which will probably have to go through a prolonged period of wage deflation combined with large – scale reallocation of resources from housing and financial services into productive users. Furthermore, any additional external financing will come at a higher cost and in limited amounts. Deleveraging of the private sector will be a drag on growth for the years to come if we consider the fact that servicing and repaying excessive debts, under stagnant or diminishing incomes. A similar impact will come from the burst speculative bubbles in the housing and real estate sectors, since the government sector will be unable to step in and compensate for the loss of private demand (Rosati, 2011).

Implications for exports from CESEE economies will remain negative since the external environment looks unfavorable. Moreover, in the banking sector of the euro area, shortage of capital and government bonds of the most indebted euro area countries combined with Basel III regulations will put additional pressure on banks to consolidate their capital base and follow more prudent credit policies, and this will reduce the resources available for the CESEE countries.

6.1. Poland

Although Poland has managed to weather the financial crisis better than the countries in the region, the country is not immune to the global slowdown and this has been obvious mainly during the last year. In the coming years, the growth outlook is expected to be bleaker, especially due to necessary fiscal consolidations. Together with weaker exports to the eurozone markets, mainly the integration into the German supply chain which has increased the country's exposure to the German business cycle and global shocks, both phenomena are likely to lead to a serious slowdown of growth that may be further accelerated if the eurozone turmoil results in problems with the financing of the current account (IMF Country Report No 13/219, 2013). Poland is a country with a chronic deficit of domestic savings, insufficient to finance the country's capital needs. Therefore, Poland has been running current account deficits for years while at the same time building foreign debt.

The banking sector remains quite strong and has reduced its reliance on FX funding. Its vulnerability to exchange rate fluctuations, as well as to the risk of freezing international financial markets is limited. However, the high share of foreign banking groups in total assets raises fears about possible contagion effects. But Stress Tests conducted as part of the recent IMF-World Bank Financial Sector Assessment Program update confirm the sector's resilience: bank capital and liquidity buffers can withstand large shocks and contagion risks are limited.

The external environment is also fraught with risks. The economy's deep integration within the EU translates into vulnerability to the eurozone crisis. Directors of the IMF observe that Poland's high trade and financial interconnectedness with Europe and open capital account make it susceptible to shocks. Household consumption has been affected by adverse confidence effects, sluggish disposable income, falling real wage growth, and rising unemployment (IMF Country Report, 13/219, 2013). The long-term outlook is largely dependent on progress in implementing important structural reforms including fiscal expenditure reform, privatization, measures to improve the business environment and raise the exceptionally low labor participation rate, as well as efforts to raise labor productivity, innovation and human capital.

6.2. Latvia

The economy has started to recover strongly although for the coming years, only a modest GDP growth is expected. Both weaker exports to the eurozone markets and a continuously tight fiscal policy are likely to result in the growth rate of about 2%-3% per annum (IMF).

The successful implementation of the EU/IMF Program and strong government commitment to fiscal discipline will most likely result in a further improvement of the fiscal balance. Latvia has managed to return to international capital markets. Besides, on July, 9, 2013 the European Council gave the green light to the adoption of the Euro on January, 1, 2014. Pressure may surface from social spending as the unemployment level in the country is high (almost 15% in 2012) and human development cannot be considered successful if poverty and social exclusion continue to grow. Continued micro-economic reforms are needed to reduce high structural unemployment, preserve competitiveness and improve growth prospects. Poor indicators for private R&D and vocational training underline the need for improvements in these areas.

The banking sector managed to stabilize its position in recent years, but the share of non-performing loans is still high (Table 3.2) and there is an ongoing risk to bank asset quality. The parent foreign banks keep deleveraging, negatively influencing the country's international reserves position. The situation of the financial sector may be aggravated in case of a perverse development in the eurozone. It would also harm the export performance of the country and can have significant negative consequences for the country's external balance.

6.3. Romania

Growth prospects in Romania rest on continued implementation of sound fiscal and monetary policies and an acceleration of structural reforms (IMF Country Report No 13/204, 2013). Growth is expected to pick up in 2013 to 1.6 percent due to a rebound in domestic demand as political uncertainty has subsided, fiscal policy is tightened less, EU-fund disbursements resume and agricultural output returns to more normal levels. The large capital inflows prior to the crisis would not appear likely to spontaneously resume anytime soon as a source of growth. The situation can become more complex once the government starts repaying its official debts, which is expected to happen in 2015.

Romania is using a flexible exchange rate policy, which constitutes as an important buffer against external shocks. Over the crisis, the Romanian leu has depreciated against the euro by more than 20%, leading to a considerable improvement of the country's competitiveness. Unfortunately, such a substantial weakening of the currency has also led to an increased level of inflation (Graph 5.2). The exposure of the Romanian economy to foreign financing is considerably high due to a permanently high current account deficit resulting from structural characteristics of the economy.

The banking sector remains relatively strong although the picture is mixed. The banks are well capitalized, however, with more than 80% of their assets controlled by foreign banks, the vulnerability to external shock remains substantial. All this contributes to make the country's exposure to external financial risk considerable. On the other hand, a relatively good situation of the public finance sector, prudent debt management and high foreign reserves can be a source of optimism.

7. Conclusions

We have identified a number of factors which developed during the years before the crisis the combination of which seems to have played an important role for the escalation of the subprime crisis in the US: the FED's monetary policy errors and deviation from the "Taylor Rule", the US government policy of promoting over – borrowing for residential purchasing even to low – income borrowers, the evolvement of securitization as a convenient tool for achieving higher yields, ineffective regulation and global imbalances are among the most important reasons for leading to the crisis.

The global financial crisis has underlined the importance of the interconnectedness of the financial systems, which explains how the developments in one part of the planet can rapidly be transmitted, through various channels, to other economies which are also tied to other economies, which initially seemed that they would not be affected.

Until the outset of the global financial crisis, the growth rates in the CESEE countries generally exceeded the EU average, reflecting a catch-up process where the new EU countries with relatively low initial income levels had been narrowing the income gap to the more developed old EU countries. It is noticeable that economic growth accelerated in most of the new EU countries in the run-up to the EU accession in 2004 and 2007 and the prospect of membership instilled confidence among financial markets participants.

We have also identified a number of factors which have made CESEE - new EU member states- exposed to the global financial crisis. Although the direct channel – toxic assets- did not work for the CESEE economies, high reliance on external finances made some of these countries particularly vulnerable to external financial shock and the reduction of Foreign Direct Investments had an immediate effect. Furthermore, the high level of economic and trade integration with the euro area led to the global shock rapidly transmitting to CESEE economies. The banking sector also came under pressure, due to tightening of global liquidity and increased credit risk. Deteriorating economic conditions led as well to higher unemployment and lower loan servicing.

In contrast to the southern European eurozone members, the main financial problem of CESEE countries is neither connected with the unreasonably high public debt, nor with the excessive consumption levels. Nevertheless, relatively low saving rates and high investment needs in these countries led to a significant accumulation of debt owed to foreigners. The bigger the country's exposure to foreign financing, the bigger the financial risk.

Looking back at what has happened since the crisis hit the region, a considerable stabilization effort has taken place. National and, in some cases, international responses prevented the crisis from having a more disruptive impact. However, the impact of the global crisis and the years of exuberance proved very costly, leading to a general sharp contraction in national output and a corresponding steep rise in unemployment. Moreover, the ongoing deleveraging process, the need to repair household and corporate balance sheets, tighter bank credit standards, could also slow the pace of the catching – up process in many CESSE countries in the coming years.

As for the three economies of the CEESE region which we examine in this study, Latvia, Poland and Romania, they exhibit different degrees of impact by the crisis as well as a different policy mix. The crisis has demonstrated that the CESEE countries are not a homogeneous lot. While they share a common history, have followed similar paths of integration with the EU and embraced a broadly similar growth model, they differ in many important respects, such as the size of their economies and domestic markets, economic structure and economic policies pursued. In general, there did not seem to be enough room for policy choices in response to the crisis, since the rapid growth of CESEE economies during the previous years was dependent on the links with their Western European neighbors who also had to face their own challenges, thus the structural weaknesses of the CESEE countries came to the surface.

The current situation perfectly illustrates the adverse effects of economic integration without social and political integration. Basic European values, such as solidarity and the idea of social Europe, were undermined by the adverse conditionalities attached by the EU (or left to the IMF) to its limited support. This fact is itself evidence of political weakness, revealing the naked reality of a Europe lacking efficient union-wide institutions. The conditionalities of the IMF bail-outs, entailing severe and rigidly applied spending cuts, undermine fragile welfare systems, threaten escalation of the crisis as well as political and social stability in the entire region. People's faith, a few years ago, that the EU Eastern enlargement would lead to economic and social convergence towards the rich EU – 15 Member State economies has been seriously shaken. Indeed, the lack of proper European responses to the crisis well called the future of a united Europe into question.

It is a sad paradox that the strong links to Western Europe and the fate of the euro are seen today – at least in the short-term – as a major liability. The structural weaknesses of the CESEE economies are likely to make the situation even more dangerous. The success depends on the flexibility of their real sector, appropriate management of the financial

institution, prudent and skilful economic policy, good regulatory framework, vigorous structural reforms, and the efficient cooperation of the government and private sector. In any case, Central and Eastern European countries should be prepared for a long period of an uncertain external environment, reduced economic growth and financial instability.

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