Who's next?

The economies of eastern Europe face stormy times, even if Western banks hold their nerve. The political fallout may be even worse

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WILL an ex-communist country be the next Iceland? The dramatic collapse of that country's economy, endangering savings from hapless depositors in Britain and elsewhere, has highlighted other risky but obscure corners of the world's financial system. The stability of the Ukrainian hryvnia, the implications of the Latvian property crash and Hungarians' troubling penchant for loans in Swiss francs are among the exotic topics now crowding policymakers' desks.

Countries such as the ex-communist ones in eastern Europe are particularly at risk during periods of financial turmoil. First, because the counterpart of soaring foreign investment has been gaping current-account deficits (Latvia's, for example, peaked at 26% of GDP in the third quarter of last year). Second, their central banks and governments are unlikely to be able to muster the financial firepower now being deployed in the big economies of the West. Already a couple of banks have toppled; stockmarkets have plunged, wiping out years of savings and hitting balance-sheets. The price of credit-default swaps-the market's estimation of a borrower's creditworthiness-ranges from the reassuring to the alarming (see map on next page). As worries intensified, Hungary's central bank on October 22nd raised interest rates from 8.5% to 11.5%.

For countries that have benefited from big flows of outside money, delivered by a highly leveraged global financial system, the mix of problems looks scary. Those big current-account deficits in every country save Russia suggest they may be living beyond their means. Some (but not all) have public or private sectors with big foreign debts; these may be hard to refinance. Some (again, not always the same ones) have wobbly banks and large state deficits. At best, the region is in for more nasty shocks that will need external support from lenders such as the IMF. At worst, some countries face debt restructuring, currency collapse and depression; that raises the spectre of political upheaval, too.

The turmoil has been most spectacular in Russia. There the stockmarket has plunged by some two-thirds since its peak in May, sending its fabled oligarchs scrambling to liquidate their portfolios to meet bankers' demands. Oleg Deripaska, probably the richest of these well-connected tycoons -now embroiled in a British political scandal (see Bagehot, page 70), has sold prized stakes in Western companies which he had pledged as collateral in the $4.5 billion acquisition of a 25% stake in Russia's biggest metals producer, Norilsk Nickel.

These wild shifts in fortunes reawaken memories of the 1998 financial crash, in which default and devaluation wiped out most of Russia's private banking system. But few expect a reprise. Thanks to $1.3 trillion in oil and gas revenues over the past eight years, Russia now sits on a mighty pile of cash and liquid assets, still in excess of $500 billion, in its foreign-exchange reserves and other funds. It is unclear how well the Kremlin will organise the bail-outs and who will benefit A lower oil price may affect the geopolitical ambitions of Russia and its allies (see page 71). Some oligarchs may become minigarchs. But Russia will not need to beg for cash from the outside world.

In Ukraine, the next-largest country in

>the region, the story is quite different The stockmarket has plunged by nearly 80% this year. The hryvnia, the national currency, recently hit a seven-year low against the dollar. The sixth-largest bank, Prominvest, suffered a run. Rating agencies have issued downgrades. Economic growth is plunging. Inflation is 25%.

The outside world wants to help. Officials are haggling with the IMF about an emergency loan of up to $14 billion-around a fifth of the $55 billion-66 billion that Ukraine needs to raise by next year to roll over short-term loans, pay interest on other debts and finance the rest of its current-account deficit. That would normally require hard bargaining about banking reform, higher interest rates and a stringent publie-spending regime to curb inflation.

The problem is that Ukraine, even by its own awful standards, is in political chaos. The prime minister and president are at loggerheads about whether an impending general election (now postponed until December 14th) is legal. A new government able to take tough decisions will not be in the saddle for weeks, even months. Keen not to be seen as too slow to assist, the IMF may stump up a loan nonetheless.

Lifelines from **outside**

The IMF is one source of help (and may be happy to have something to do after years in which its role in the region seemed to be shrinking). For countries closer to "old Europe", another possible provider of assistance is the European Central Bank. On October i6th the ECB provided a short-term credit line of €5 billion ($6.7 billion) to Hungary, which is not in the euro zone but has an economy closely linked to it. The foreign-exchange market there had all but seized up amid worries about debts, public finances and growth prospects.

Although much richer than Ukraine, with GDP per head roughly three times as high, Hungary is in some senses even more vulnerable. Public debt is more than 60% of GDP (a lot by the region's standards), thanks to a communist-era borrowing spree and spendthrift governments since then. In 2006 the budget deficit exceeded 9% of national income. The current-account deficit this year amounts to €6.8 billion, or 5.5 % of GDP. Recent debt auctions have been cancelled because of a buyers' strike. Many Hungarian households and firms have taken out hard-currency loans (such loans, originally at much lower interest rates than forint-denominated ones, account for 90% of new mortgages since 2006 and 20% of GDP). In effect these were personal bets, now looking ill-judged, on the convergence of the forint with the euro. The weak forint already means higher interest payments; if that trend continues, many Hungarians risk bankruptcy.

Hungary's economy could certainly be in better shape. But outsiders give the authorities credit for efforts in the past two years to cut the budget deficit, now slightly less than 4% of GDP. The government has started cross-party talks on a further austerity programme. The Hungarian central bank is impressively well-run. The IMF and ECB are ready to lend more if needed.

The huge question, in Hungary and elsewhere, is whether foreign banks will stand by their local customers. Like most of the new members of the European Union, Hungary has sold off most of its banks to outsiders. That once looked the best way to create a solid financial system, allowing countries to borrow freely and grow fast, without risking the kind of crisis suffered by emerging markets in past decades. In retrospect, it looks risky. For the past decade Western banks, such as Erste Bank

and Raiffeisen (Austria), UniCredit (Italy) or Swedbank and SEE (Sweden), have piled in to the promising new markets on their doorsteps, lending boldly and buying up sometimes richly priced local banks. Now those huge loan books—in Austria's case fully 43% of GDP, compared with 5% for Italy and 1% for Sweden-are souring at a time when wobbly banks may feel that scarce cash is better deployed at home. Such deposits abroad are not covered by home-country insurance.

The foreign banks are already reining bad; lending, refusing to issue mortgages in foreign currency and demanding better security. That is prudent, if belated. The danger is that they may go much further, cutting off new lending or refusing to roll over outstanding loans, even to solid borrowers. That could send bankruptcies and unemployment rocketing. Another possibility is that one or more parent banks will put a troubled subsidiary up for sale, perhaps to a Russian buyer. That prospect is unlikely. But it sets nerves jangling in places such as the Baltic states.

At first sight it Is these economies that seem in the riskiest position. A sharp slowdown had started even before the global financial crash. Estonia and Latvia in particular had enjoyed remarkable property booms, generously financed by bank lending. That was one factor in their colossal current-account deficits. The bubbles have popped; growth, running in double digits in 2006, has come to a halt.

This has been a hard but so far orderly landing. Whether it now turns catastrophic is an open question. The debts must still be repaid. Fitch, a rating agency, which downgraded all three Baltic countries this month, reckons their gross external financing requirements next year (the money they need for foreign debt repayments and their current-account deficits) are 400% of likely year-end foreign-exchange reserves in Latvia, 350% in Estonia and 250% in Lithuania. These are the highest ratios in emerging Europe.

In theory, the external imbalances should unwind of their own accord. The slowdown at home is already shrinking current-account deficits. If the local banks run out of money because of bad loans, their foreign owners will send them more cash; the sums involved are big by Baltic standards, but small by the standards of rich-country banks. Swedbank, for example, has 16% of its loans in the Baltic states, (190 billion Swedish kroner, equivalent to $32 billion or €20 billion). Only 1.2% of the total look bad so far, the bank says. Sweden's regulators say the biggest banks can write off as much as 10% of Baltic lending without eroding their own capital. Sweden launched a $200 billion bail-out plan this week to bolster confidence.

Furthermore, despite,, ,the ballooning foreign borrowings of firms and households, none of the Baltic states has much public debt to worry about (Estonia even has net assets). Public finances are solid. The governments still have investment-grade credit ratings.

Pegs and their dangers

The problem is not so much survival, as finding the right policy mix to minimise the effects of sharp slowdown. All three Baltic states have their currencies pegged to the euro, either in formal currency boards (where the amount of money in circulation is directly linked to foreign-exchange reserves) or, in Latvia's case, in a similar but slightly more flexible arrangement. That was a shrewd move in the 19905, when it helped to stabilise economies left prostrate after the collapse of Soviet planning, and was a good way of keeping on track for eventual membership of the euro {something Lithuania missed

by a statistical whisker in 2006). It is made safer by the fact that none of the countries is a financial centre: shorting the Icelandic krona was child's play compared with the difficulties of speculating in the thinly traded Latvian lat or the Estonian kroon.

The main disadvantage of the arrangement is that it limits policymakers' flexibility. If outsiders suddenly pull money out of a country with a pegged currency, the money supply shrinks, risking a deep depression. A country with a floating exchange rate can try to restore competitiveness and stoke growth by devaluing the currency. For any of the Baltic states, a float would be a catastrophic humiliation. It would also not necessarily help matters: for small countries, the risks of a free-floating currency are greater and the benefits less. So the likelihood is that the three Baltic countries face at best, big cuts in public spending and lower output, perhaps for several years, while they pay off their debts and regain competitiveness. In happier conditions the governments would run deficits to counter this. In the current gloom, more borrowing risks making outside lenders feel even twitchier.

Most of the EU'S new members are in a stronger position, and should scarcely be put in the same category as the problematic countries. Poland, for example, has public debt of around 40% of GDP, while growth is nearly 6% and inflation at 4.5%. A strong economy has meant healthy tax revenues and kept budget deficits down. The zloty, like the Hungarian forint, has been wobbly, and a sharp slowdown in western Europe, the biggest export market for all ex-communist countries, will affect Poland too. But life should be at worst a bit tougher, rather than downright nasty.

The price of corruption

Potentially more vulnerable are the poorest new members of the EU, Romania and Bulgaria. For now, growth in both countries remains strong. But the imbalances are striking: Bulgaria's current-account deficit is likely to be 24% this year. Bursting property bubbles and a wave of corporate bankruptcies could expose the poor quality of banks[1] loan books. The question then will be how much support and attention either country will receive from outside. Whereas the Baltic states are well-regarded, enthusiasm in the EU for a Bulgarian bail-out is likely to be limited, thanks to the failure of the authorities in Sofia to fulfil commitments to clean up organised crime and corruption.

And that is the deeper problem for eastern Europe: not so much financial wobbles and weaknesses, but corrupt and incompetent politics. Their leaders found it hard enough to govern efficiently even when times were good. What will happen when foreign investors are stingier and growth slows or stops?

Ever since the collapse of communism in 1989, the eastern half of Europe has been struggling to reach the levels of economic, social and cultural development of the west. The ruinous legacy of one-party rule and planned economies was daunting. Everything from the rule of law to competitive companies needed to be rebuilt (in the case of the central European countries) or constructed from scratch (for those whose pre-cornmunist experience was of autocracy or feudalism).

The results were impressive. Living standards soared; foreign investment poured in; politics settled down. The richest ex-communist countries are now nearing "Western" countries such as Greece and Portugal. So the fears of some in "old Europe" in the early 19903 that the new

neighbours were likely to be poverty-stricken and unstable, exporting hungry migrants and crime to the rest of the continent, looked ridiculously overblown. Expanding the EU and NATO eastward went from a preposterous fantasy to common sense. One small ex-communist country, Slovenia, has joined the euro; another, Slovakia, will do so in January.

The next few years are likely to be a lot harder. A sharp recession will expose the cost of stalled reforms in previous years. In most of the ex-communist countries, the effort to meet EU and NATO requirements was a high-water mark in terms of political commitment to good government and sound economic policies. Since then, the approach has been to sit back and enjoy the weather: low borrowing costs, high foreign investment, rising tax revenues and higher living standards. Voters may not have thanked governments for this, but the political pressure to take painful decisions has been minimal. (The only real exception has been Hungary, where capital markets sent a sharp warning two years ago.)

Testing democracy

Now more than ever, the countries of the region need to push ahead with tough but urgent policies such as public-finance reform, especially of pensions; raising labour-market participation, particularly by reducing the numbers of early retirees; and improving productivity by modernising education, which is often still hidebound by communist-era bureaucracy. Countries such as Poland and Latvia still have shamefully bad road systems. Officialdom chokes business; corruption is stubbornly entrenched.

But the chances of a big push on reform look slim. The political compass, which once sent a reliable, if often ignored, message about the needed direction of policy, is swinging wildly as Western governments break taboo after taboo in the hope of fending off financial meltdown. For countries that have been told that privatisation, liberalisation and balanced budgets are the sure path to salvation, these are confusing times. The result, says Ivan Krastev, a Sofia-based pundit, is "an implosion in the idea of normality".

The wrong kind of certainty may be even worse than confusion. The political institutions of the ex-communist countries were created in the great flush of optimism that followed the collapse of the one-party state. But voters have grown steadily disillusioned with politics. A seasoned watcher of the region in Brussels says that the coming years "will be a big test of democracy and the rule of law.. .will they stick to the rules?" If things get nasty, blaming economic hardship on foreign banks that have taken deposits but don't want to make loans may prove a tempting theme for ambitious populist politicians.

For countries still outside the main clubs, prospects are even bleaker. The chances of fragile countries such as Macedoniajoining the EU any time soon are diminishing. So are the prospects for the more advanced countries that want to join the euro. A cash-strapped EU may think again about the money it is prepared to spend on infrastructure and public services in neighbouring non-members.

In the eyes of many it is market economics, even more than democracy, that has been the big success of the past 20 years. It has brought undreamed-of freedom, choice and prosperity. In some countries, Mr Krastev notes, foreign banks have scored more highly in trust rankings than any public institution. They have become the symbolic and financial linchpins not just of economies, but of whole countries. They have a lot to lose. So does Europe. ■

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