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East Europe Rides Out the Economic Storm

JANUSZ BUGAJSKI

During the past year, as recession has swept relentlessly across Central and Eastern Europe, the countries that are Europe's newest democracies and the European Union's newest members have experienced crisis for the first time since their transition away from authoritarianism. While some doomsayers and a few Marxist diehards predicted that the crisis would cause the demise of liberal economics in the region and even bring significant reversals in democratic consolidation, the picture that has emerged is much more nuanced and less apocalyptic.

Despite dire initial forecasts, no wholesale economic, banking, or currency collapse has occurred in Central and Eastern Europe (CEE)—the region that encompasses Europe's formerly communist states. (This includes the Eastern bloc countries west of the post–World War II border with the Soviet Union, the independent states of the former Yugoslavia, and the three Baltic nations.)

No CEE country has thus far defaulted on its debts, no reversals in reform efforts have been evident, and no systemic political failures have occurred, though several governments have been replaced. Likewise, social unrest and organized political extremism have been limited. No surge has been seen in yearnings for the pre-market system, state control of the economy, or national protectionism and isolationism.

In short, though the region has been economically battered, it has largely weathered the storm. Nonetheless, each Central and Eastern European country is bracing for further economic and social challenges, which will continue to test the stability of political institutions.

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MARKET SHOCKS

Economic analysts have appraised the new EU members from Central and Eastern Europe in terms of the impact that the recent recession has had on them and placed the countries into three categories: the resilient, the uncertain, and the suffering. For the countries in each of these categories, long-term political implications exist.

The "resilient" group consists of those countries that have most readily endured the economic upheaval. They display relatively strong macroeconomic indicators and are pursuing prudent fiscal policies. In three such countries—Poland, Slovakia, and Slovenia—domestic politics has remained stable. In the one such country—the Czech Republic—where a government has been replaced, it was not a direct consequence of the economic crisis, but rather because of internal scandals, political infighting, and narrow electoral majorities.

The "uncertain" group consists of countries that have only partially coped with the economic downturn and face further disruptions as the effects of falling exports, limited investment, and restricted credit become more apparent. These countries include Lithuania, Estonia, and Bulgaria. The "suffering" group is made up of those countries in which the economic pain has been most severely felt and where, largely as a result of a "shock decline" in credit and foreign capital, governments have fallen. Latvia, Hungary, and Romania fall in this category.

In addition, conditions among EU aspirants bordering the CEE region appear extremely mixed. Nations that are heavily indebted to foreign lenders, such as Ukraine, face acute economic problems, while countries less dependent on financial markets, including Albania, have avoided the worst of the storm.

As a result of the financial crisis, a credit crunch, and a prolonged recession, most CEE economies have shrunk for the first time since they began to undergo systemic transformation in the early 1990s. During the past decade, the region had experienced an average growth rate of almost 8 percent per year. In 2009, however, gross domestic product across the region was estimated to have declined by 6.2 percent, and only modest recoveries are forecast for 2010.

In the most severely battered states, GDP growth had been driven by heavy external borrowing, which exposed these countries to financial squeezes. All CEE states except for the Czech Republic ran current account deficits in 2008 of more than 5 percent of GDP. The deficits of some Balkan countries, including Bulgaria and Serbia, were as high as 20 percent of GDP. Thus the region was especially vulnerable to the global credit crunch.

The three Baltic countries of Latvia, Estonia, and Lithuania were the first to suffer; their housing bubbles burst in the fall of 2008. By the end of that year, the disappearance of credit and a steep drop in consumption began to affect the entire region. Throughout 2009, CEE countries witnessed export declines of up to 30 percent. Unemployment rates soared into double digits. Foreign direct investment shrank, with little prospect of staging a strong return. Recovery today remains contingent on maintaining fiscal discipline and attracting new investors, as well as on the speed and scale of recovery in Western Europe.

The economic storm raging across Europe will probably place EU enlargement on hold.

Among the EU members that have joined since 2004, Hungary has experienced the greatest financial problems because it had accumulated substantial foreign debts and relied excessively on cheap international credit. The crisis in global credit markets restricted Hungary's access to international financing, and Budapest needed a $16 billion assistance package from the International Monetary Fund (IMF) to prevent a balance of payments crisis. Romania has also been vulnerable to financial market turmoil, and witnessed a GDP drop of over 7 percent in 2009.

The Baltic states, of course, underwent a major downturn after their housing bubbles burst, with GDP contractions for 2009 estimated to exceed 18 percent in Latvia and Lithuania, and 13 percent in Estonia. (This was mainly because of these nations' large current account deficits and their difficulties in obtaining fresh credit.)

Meanwhile, to streamline government spending, states across the region have cut public sector jobs, reduced pensions and state salaries, and curtailed expenditures on public services. And the new middle classes of Central and Eastern Europe have suffered a serious economic reversal because, believing the boom times would last indefinitely, they had accumulated substantial debts.

POLITICAL WAVES

Several governments in the region have fallen largely because deteriorating economic conditions reduced their parliamentary support and provoked political ruptures in ruling coalitions. However, there has been no domino effect through the region, and no lurch toward leftist or rightist radicalism. Fallen governments have been replaced by new center-right or center-left coalitions, while electoral support for ultranationalists or radical populists has remained limited.

The most obvious indicator of voter dissatisfaction has been low turnout in national elections, and especially for the European Parliament (EP) elections in June 2009. Several extremist groupings in CEE countries profited from the economic malaise and gained EP seats in excess of their popular support—they were better able than the larger parties to mobilize their electoral base. A similar situation prevailed in Western Europe, where radicals from Britain, Holland, Austria, and other nations also gained EP seats.

It is unclear, however, whether a greater role for radical groups in the EP, and their opposition to further EU integration, will raise their stature and increase their electoral support. Several CEE countries, including Slovakia, Hungary, and the Czech Republic, are due to hold parliamentary elections in 2010. These will be closely monitored for any surge in support for extremists.

Paradoxically, the CEE countries that experienced the fastest GDP growth in the past decade—Latvia and Hungary in particular, as well as Estonia and Lithuania—have since 2008 suffered economic decline most acutely, because they were overly reliant on large-scale lending in the financial markets. This has been very disorienting for citizens, who must face unfulfilled or suddenly deflated expectations.

Thus Latvia's center-right government resigned in February 2009 under immense political and social pressure (there was rioting), as the government confronted an enormous budget deficit and the nation's economy faced bankruptcy. The successor center-right coalition government has implemented severe austerity measures and made strenuous efforts to explain to the public the necessity of drastic expenditure cuts to avoid a more intense crisis.

Hungary's Socialist administration has precipitously lost its support base since the onset of the recession. The government faces growing resentment over its policies amid a steep decline in gross wages for public employees. Mass protests and political infighting regarding how to deal with public spending led in March 2009 to the resignation of Prime Minister Ferenc Gyurcsány and his replacement by the "independent entrepreneur" Gordon Bajnai. The opposition, center-right Fidesz-Hungarian Civic Union party looks set to win parliamentary elections in the spring of 2010 despite Bajnai's efforts to stabilize the economy.

Hungarian commentators have warned about the rise of the ultranationalist and anti-minority Jobbik party, which is feeding off public disaffection and could gain a sizable parliamentary bloc. Jobbik came in third in the EP elections in June 2009 with almost 15 percent of the vote and is projected to capture some 10 percent in national elections. However, the leaders of both major parties say they will not enter into a coalition government with Jobbik. The more immediate danger in Hungary and other countries facing parliamentary elections in 2010 is the temptation for the governing party and the opposition to ease off on supporting essential austerity measures in order to secure electoral support.

NO CONFIDENCE

Romania is experiencing political turbulence in the midst of a growing economic crisis and a mushrooming budget deficit. Public service workers have staged protests against job losses and static or falling wages. The narrow and disputed reelection of President Traian Basescu in December 2009 has hindered the emergence of a stable government; the new administration only has a slim parliamentary majority. Indeed, the country was without a government between early October 2009 and the end of December following the ouster of the minority administration of Prime Minister Emil Boc in a parliamentary no-confidence vote. Several attempts by Basescu to nominate a new government failed, producing gridlock between a caretaker administration and the parliamentary majority.

Romania's political conflicts have harmed the country's economy. The draft of the government's 2010 budget was frozen for several months, and the third tranche of an IMF loan was postponed until the passage of a new national budget. Parliament finally approved the budget in mid-January 2010, but continuing uncertainties about state spending may have serious implications for fiscal discipline and could even precipitate a crisis in Bucharest's debt repayments. The full package of credits from the EU, IMF, and World Bank amounts to 20 billion euros; this has saved the country from outright bankruptcy.

The Czech government of Prime Minister Mirek Topolanek lost a parliamentary no-confidence vote in March 2009. A provisional administration of "experts" was formed under Prime Minister Jan Fischer and was due to hold office until the spring of 2010. However, the fall of the government was not the result of the Czech Republic's huge foreign debts, disappearing credit, or severe austerity measures. Instead, Topolanek was brought down by government corruption scandals.

Bulgaria held elections in the midst of the economic crisis in July 2009. The Socialist-led coalition government was soundly beaten by a new center-right party, Citizens for the European Development of Bulgaria, led by Prime Minister Boiko Borisov, who pledged to root out official corruption and state mismanagement. The ultranationalists did not greatly benefit from the economic troubles, increasing their vote share by only 1.3 percent compared to the 2005 elections. However, there are fears that if the economic crisis persists, the new Bulgarian administration will yield to pressure to increase public spending and thus worsen the financial picture and preclude large-scale international assistance.

Recent opinion polls in much of Central and Eastern Europe indicate that a majority of ordinary citizens distrust their political elites and much of the business class, who they believe have benefited unfairly from economic reforms and are not suffering from the recession. However, in no country does majority support exist for a return to state control, although some sectors of the population favor a strong-handed leader.

In most states, citizens simply want a competent, honest government with a viable economic program. This helps explain why new political parties emerge during each election cycle and gain significant popular support—before withering away at the next general election, as the public becomes disillusioned because of unmet campaign promises. However, the democratic systems themselves in Central and Eastern Europe are not under serious threat, and each country's institutions seem sufficiently resilient.

WEST AND EAST WINDS

In several CEE countries, significant sectors of the population believe that EU integration has actually damaged their national economies and contributed to the recession. According to a Pew Research poll taken in the fall of 2009, 71 percent of Hungarian citizens view the EU's economic impact negatively, as do 63 percent of Bulgarians. (It is worth noting that this sentiment is not confined to Central and Eastern Europe: In France the number stands at 55 percent, and in Britain it is 54 percent.)

Yet, despite these figures, general elections among the CEE countries have not favored anti-European movements, and mainstream parliamentary parties continue to support deeper EU integration. In Poland, for instance, after six years of the country's EU membership, electoral support for Euroskeptics has declined. Throughout the region, mobilization against the Lisbon Treaty, which is intended to strengthen the EU, has gained only limited traction.

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Contrary to public perception in some EU member states, a "new Iron Curtain" has not descended between the union's old-timers and newcomers—as Gyurcsány, the ousted Hungarian prime minister, claimed at an EU summit in March 2009. The benefits accruing from EU membership, including structural and financial support and emergency assistance, have proved essential to maintaining a measure of economic stability during the recession and will be important for stimulating future economic growth.

Hungary, Latvia, and Romania, burdened with significant budget or current account deficits, have each received large-scale loan packages from a co-financing mechanism initiated by the European Commission and the IMF. The European Central Bank has also provided short-term euro loans to Poland and Hungary, and most West European banks have bailed out their CEE subsidiaries. Both Slovakia and Slovenia, having adopted the euro, remain relatively immune from the currency volatility evident in much of Central and Eastern Europe.

Ultimately, while EU accession does not fully shelter countries from economic hardship, membership does ensure interdependence and shared responsibility for economic stability, and it is safer than being outside the union. Clearly, the EU will not allow systemic banking failure or national default in any member state, and it has worked closely with international financial institutions to provide emergency assistance.

Many fear, however, that the EU will now be less focused on countries neighboring the union, especially those in the Eastern Partnership Program (EPP), which was launched in May 2009 with Ukraine, Belarus, Moldova, Georgia, Armenia, and Azerbaijan. The economic downturn has reduced support within the EU for closer trade relations, visa-free travel, and other economic benefits for the EPP states. It has also diminished the capabilities of Central European capitals to assist their eastern neighbors, and reduced the attractiveness of the EU in several EPP capitals.

In addition, the financial crisis has served to expose high levels of official corruption among several new EU members and aspirants, and has exacerbated public perceptions of widespread malfeasance. Organized corruption has a negative impact on economic development, as state funds are used in ways that benefit private interests instead of being invested in public projects. Corruption also scares off Western investors, most of whom refuse to involve themselves with non-transparent business practices. The net effect of endemic corruption is that a country becomes poorer as officials tied to opaque interests become richer. This can have a devastating impact during a prolonged economic recession.

Another consequence of the failure to tackle organized corruption is that it can expose a vulnerable country to Russia's state-directed business penetration and political influence. Whereas official corruption in Europe largely serves private interests, in Russia it serves the political interests of the Kremlin. In fact, corruption has become a fundamental feature of government policy in expanding Moscow's influence. Kremlin leaders aim to embroil officials in targeted countries in business arrangements that favor Russia's energy interests and business expansion. Non-transparent commercial transactions can in turn increase Moscow's influence over foreign policy in parts of Central and Eastern Europe.

Countries such as Bulgaria, Romania, Croatia, and Serbia, which are suffering from ballooning state debts, budgetary shortfalls, and declining foreign investment, are tempted to sign Russian energy contracts that may promise substantial profits and regular energy supplies but could in the long term promote even more extensive official corruption and dependence. Although the Russian government lacks the resources to bail out any former satellite, it has exploited the recession to make loans and investments in neighboring post-Soviet states that carry specific political conditions.

SHIPWRECKS AHEAD?

Both pessimistic and optimistic scenarios abound regarding the pace of economic recovery and the future of political stability in Europe's East. Pessimists believe that, unlike in Western Europe, the new democracies are too weak to bail out or renationalize significant parts of their economies, and that resources are lacking to cope with a prolonged financial and economic crisis. Additionally, they suggest that convergence between older and newer EU economies will slow because of the recession.

Under this negative scenario, a single CEE country defaulting on its debts could precipitate a landslide and discourage foreign investors from operating throughout the region. Meanwhile, all CEE states will compete with each other for a declining number of foreign investors, and their West European counterparts might adopt more protectionist measures to defend their national economies.

According to the pessimists, several potentially destabilizing trends warrant close monitoring by policy makers. Prolonged economic hardship traditionally produces assorted extremist movements, which are especially unsettling if they tap into youth frustration fueled by extensive job losses. As the recession continues, some analysts predict that—in addition to the crisis currently affecting pensioners and state workers—the new middle class in Central and Eastern Europe will collapse and populist nationalism will rise. This might push some mainstream parties to adopt more radical and discriminatory programs toward, for instance, minorities, immigrants, or political opponents.

One might witness the election, or inclusion in government, of populists or nationalists advocating a "strong hand" approach to economic and social problems and political gridlock. Ultranationalist formations are currently included as minority parties in governing coalitions in Slovakia and Bulgaria, and they have gained a new lease on life in a number of other states, including Hungary. Although a similar phenomenon is occurring in parts of Western Europe, there are fears that democratic institutions in some countries may not be strong enough to withstand an extremist surge if economic conditions deteriorate for a prolonged period.

In addition, widespread economic dislocation could greatly increase ethnic polarization and even provoke conflicts with minorities who may be perceived as benefiting from the recession. Among the new EU members, Slovakia and Romania appear to be the most vulnerable in this regard, since both contain sizable and well-organized Hungarian populations. Some countries could witness the growth of substate regionalism, which might assume an ethnic and even autonomist or separatist dimension. Where the central government is seen to be failing to deliver economic resources, regional loyalties toward the capital may diminish.

Profound economic pain and social turbulence may convince some governments to backtrack on their reform programs. In the most serious cases, this could mean political regression through restrictions on democratic procedures such as election laws, media access, or parliamentary thresholds. In such conditions, political polarization and national bifurcation could sharply increase. Some societies might split into two camps, with little room for negotiation and compromise. If an opposition is elected, new leaders might seek various forms of political revenge against their losing rivals through means such as filing corruption charges.

On the international stage, one could expect an assertive and opportunistic Russian government to exploit social, political, ethnic, and regional turmoil—especially in states whose administrations are seen as Russophobic, as in the three Baltic nations, or where Moscow seeks greater influence over countries' foreign and security policies. At the same time, pessimists envision declining support for international institutions such as NATO and the EU, and greater stress on "national roads" and protectionist measures to overcome the crisis or to shield states from further regression. The West Europeans could also adopt more national models of economic recovery and development, thus seriously undermining EU unity and limiting assistance to the new members.

A CLOUD OVER THE BALKANS

A longer-term danger hangs over the western Balkans in particular. The economic storm raging across Europe will probably place EU enlargement on hold, and it may indefinitely postpone the entry of candidates and aspirants for union membership from the Balkans after the expected accession of Croatia by 2011. Governments in Germany, France, and the Netherlands have signaled that allowing new states into the union could increase public opposition at a time when national defensiveness is on the rise as a consequence of the economic slowdown.

The Balkan states could be entering a vicious cycle whereby denial of EU entry, combined with economic crisis, might stall the political and economic reform process. This would in turn retard economic growth—and lessen each country's qualifications for EU accession by stimulating the negative forces that hinder it.

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Based on the geographical position and foreign trade structure of the current EU aspirants in the western Balkans, membership in the union remains the only viable foreign policy option. These economies, which initially appeared to be relatively protected against the crisis because of their low levels of export dependence and external borrowing, will face growing economic problems as the recession continues to ripple across the region.

The poor business environment that typifies much of the region further handicaps all of the national economies. IMF efforts to encourage western Balkan governments to rein in budget deficits will make the impact of the ongoing crisis even more painful for citizens, and recoveries are not expected until 2011.

Older EU members also are not immune from social turbulence if economic conditions stagnate. West European countries with large and unassimilated minorities and sizable immigrant populations may become increasingly prone to social tensions and perhaps conflict. Economists also warn about the dangers of national protectionism and economic isolationism in the absence of sustained economic recovery.

The impact of such trends in Western Europe could prove catastrophic, not only for the CEE economies that would be starved of capital and funds, but for the entire EU, much of whose industrial capacity is now located among the new member states.

THE INTEGRATION DIVIDEND

Optimists, in stark contrast to the pessimists, calculate that Central and Eastern Europe is simply going through an economic cycle and will return to respectable growth, albeit at a lower level, once the recession has run its course. The new economies outstripped their West European counterparts over the past decade and their growth would have eventually slowed even without the worldwide slump. Some economists are even predicting that the broad CEE region, with a combined GDP already equal to Brazil's, will become a significant global economic player.

For the optimists, most of the CEE countries exhibit long-term structural strengths, including political stability, a solid institutional framework, a highly educated population, the rule of law, openness to foreign direct investment, an inflow of substantial EU funds, eagerness to adopt the euro, and increasing convergence with the older EU economies. According to this view, intensifying EU integration will increase investment, raise labor mobility, encourage adequate policy making, and sideline the nationalists and populists.

Moreover, because of deepening interdependence among states, other EU members have an interest in not allowing any CEE economy to declare bankruptcy—lest their own banks and companies suffer as well, and the union as a whole enter a period of unpredictability and instability. This growing interdependence is mirrored in the political realm, where the Lisbon Treaty, designed in part to improve coordination of foreign policy, went into effect on December 1, 2009, following approval by all EU governments.

In fact, neither the pessimists nor the optimists have grounds for certainty, because so much depends on factors that cannot easily be forecast. These factors include the strength of the global economic recovery, particularly in Western Europe; the condition of the financial sector, both in the region and elsewhere; the diversification of CEE countries' exports and investments; the timing of adopting the euro in specific states; and the pursuit of economic development models that can take advantage of new industries and new technologies.

A prolonged post-crisis recovery is likely to result in greater economic diversification across Central and Eastern Europe as competition for capital and markets increases. Foreign investors are likely to favor countries with more stable economies, predictable governments, lower corruption levels, and a better business climate.

Over the horizon

As the economic storm continues to rumble through Europe, analysts are unable to predict when economic performance will hit rock bottom and rebound in Central and Eastern Europe. In a report issued in June 2009, the World Bank warned that the CEE and the western Balkan economies are likely to recover more slowly from the global crisis than are other developing economies. Regardless, even after the recession formally ends in the CEE region, social and political repercussions will be felt for many years—and certainly through the next general election cycles.

Among the more economically resilient states, where incumbent governments have survived or new centrist coalitions have taken office, steady economic performance depends increasingly on upholding fiscal discipline and reducing public budget deficits. The region's economically uncertain countries, which may not have faced their most severe challenges yet, will need to draw lessons from more resilient neighbors and might require long-term EU assistance. The suffering states will take longer to rebound, but they may have already hit bottom. In any case, they will need to maintain anti-recession policies indefinitely, in combination with more coordinated, long-term EU aid.

The majority of people in Central and Eastern Europe displayed patience and resilience during the traumatic transition from state socialism to liberal capitalism. Since the recent economic crisis hit, most have remained largely passive but tolerant of government policies. Radical, revolutionary, or revisionist political forces still have only limited appeal. And no CEE government has adopted, nor has any major opposition party supported, nationalist and protectionist economic prescriptions.

For the time being, the new post-socialist democracies have demonstrated their adaptability and stability under enormous economic stress. Predictions of massive social unrest, political breakdown, or reformist reversals have, to date anyway, proved misplaced. Nonetheless, there are too many unknown variables, including the full depth of the Europe-wide recession, to predict with any certainty the social and political repercussions of continuing economic decline, long-term stagnation, or even a gradual and prolonged economic recovery. ■