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THE EU'S ROLE IN SUPPORTING CRISIS-HIT COUNTRIES IN CENTRAL AND EASTERN EUROPE

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Highlights

- The crisis hit central and eastern Europe (CEE) hard. GDP forecasts for 2010 for 30 countries in the region were adjusted downwards by an average of 15.8 percent between October 2007 and October 2009. This marks a major reversal because, before the crisis, CEE countries seemed to be benefiting strongly from membership of, or closer ties with, the European Union.
- The EU and its institutions have mobilised substantial funds to support crisis-hit CEE countries. Coordinated multilateral financial assistance has had stabilising effects, and the banking system has played a crucial role. Western European banks have remained committed to the region.
- However, certain actions, or failures to act, on the part of EU institutions and governments, have amplified the effects of the crisis on CEE countries. The European Central Bank has given little direct support to non-euro-area countries, and the EU has done little for EU neighbourhood countries. Meanwhile, euro-area membership has shielded from the crisis some countries with worse fundamentals than certain CEE countries.

This policy contribution was prepared as a background document for the volume: Mitra, Pradeep, Marcelo Selowsky and Juan Zalduendo (2009) [illegible], World Bank, Washington DC. The author is grateful for their comments to Pradeep Mitra and Jean Pisani-Ferry.

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THE EU'S ROLE IN SUPPORTING CRISIS-HIT COUNTRIES IN CENTRAL AND EASTERN EUROPE

ZSOLT DARVAS, DECEMBER 2009

1. INTRODUCTION

Countries from central and eastern Europe (CEE) have been hit the hardest by the crisis, compared to other regions of the world. Figure 1 shows that in October 2009, the weighted average 2010 GDP level of 30 CEE countries was forecast to be 15.8 percent lower than was expected in October 2007[1]. There has been less downward revision in other emerging and developing country groups, ranging from 5.9 percent (average of 13 countries in the Middle East) to 7.5 percent (average of 25 Asian countries, excluding China and transition economies in Central Asia). The main epicentre of the crisis, the US, has suffered a 7.4 percent downward revision, while downward revision was 8.8 percent for the EU15. Figure 1 also indicates that there is great heterogeneity among CEE countries, and only a few of them have fared better than the EU15 average.

1. In our view, comparison to a benchmark, ie the downward revision of the forecast level of GDP at a future date, is a better measure of the severity of the crisis than the actual fall in

Before the crisis, CEE countries seemed to be catching-up quickly and smoothly. The successful transition and pre-crisis catch-up process stood on four pillars:

1 Political and institutional integration into the EU, with ten CEE countries becoming EU members between 2004 and 2007, and higher hopes for many others for future membership;
2 Financial integration into the EU, which has led to, for example, significant foreign direct investment and lending to CEE countries, and also to the dominant position of western European banking groups in the banking system of most countries in the region;
3 Trade integration into the EU, as the EU became the dominant trading partner for most CEE countries;
4 Migration flows into the EU, as some countries in the region have experienced very large outflows of workers to western European countries, helping them to acquire new skills and achieve better living standards.

EU integration was not just beneficial to CEE countries but also to western Europe, as demonstrated by, for example, the assessment of the 2004/07 enlargement round by the European Commission (2009). EU integration, on the other hand, also contributed to the build-up of various vulnerabilities, such as huge credit, housing and consumption booms, and consequousing an0,e insp(p)14.p5763 Tw08 [(c)11.2(n0.8(atio)1l0s20703 Tw [(s)6.hi.7.2((p)14.p5763

this initiative is part of the EIB and EBRD activities discussed above, it has a crucial role and it is hence important to emphasise it separately, not least because of its coordinated nature and the participation of the World Bank. The financial support will include equity and debt finance, credit lines and political risk insurance.

Foreign ownership of CEE banks. A large proportion of the banks in CEE countries is owned by western European banks. Without western ownership, banks in the region would probably have been denied euro liquidity altogether. The commitment not to let any systemically-important bank fail in the euro area and also in Sweden (whose banks own most of the banking system in the Baltic countries), the EU political commitment that packages helping international banking groups can benefit subsidiaries, and the ECB's liquidity support to euro-area banking groups, also helped their subsidiaries in the CEE region[4].

The 'Vienna Initiative'. This is a multilateral effort to secure financial sector stability in those CEE countries with substantial foreign bank ownership. It stipulates coordination between all relevant stake holders, including international banking groups, home- and host-country authorities, international financial institutions and the EU, with the aim of developing a common understanding. It aims to secure the commitments by both international banking groups and home and host-country authorities, and to coordinate a fair burden sharing (see Box 1.4 in EBRD 2009).

Agreements between European central banks. Table 2 summarises the main liquidity provision agreements between European central banks. Three CEE countries (Estonia, Latvia and Lithuania) are participating in the EU exchange rate

4. Statistical analysis
RD8.

(Commission press release IP/09/204). On 31 July 2009, the EU approved a €100 million grant to Serbia from the IPA budget (Commission press release IP/09/1213) and, on 11 August 2009, a

to meet. European officials did not initiate the adaptation of the entry criteria to the new circumstances, though the European Council has the ability to reform the criteria without a formal treaty change (Darvas, 2009b). This resistance to change disadvantaged countries that were seeking the stability and credibility offered by euro-area membership.

4. ASSESSMENT

The crisis has hit central and eastern European countries harder than other regions of the world. To express solidarity, but also to recognise the EU's responsibility toward a region that is highly integrated in political and economic terms intyysrmf

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supports to new member states and other neigh-

BOX 1: THE EURO SHELTER: HUNGARY VERSUS GREECE