CENTRE FOR EUROPEAN REFORM
briefing note

NEW EUROPE AND THE ECONOMIC CRISIS

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★ The EU's new member-states have been severely hit by the credit crunch and collapsing export markets. Many had left themselves vulnerable through fiscal profligacy, lending booms and gaping external deficits.

★ Most rich countries in the EU are boosting fiscal spending to mitigate the downturn. But some of the new members are being forced to cut budgets by IMF emergency programmes. In the others, higher public spending cannot make up for falling export demand.

★ The immediate feeling of helplessness of the Central and East Europeans is compounded by a more profound sense that their post-Cold War growth model is broken. The ingredients of past success – opening up to trade and investment and selling local banks to West European ones – has left these countries vulnerable. The EU, which acted as an anchor for reforms in the past, has lost clout and credibility.

★ The new member-states have no time for procrastination or recrimination. Faced with the near-term challenges of ageing populations, fierce global competition and tougher green targets, they need to improve, not discard, their economic model of liberalisation and integration. But they will need the EU's help.

Many parts of the world claim to have been particularly badly affected by the economic crisis, but that is truer for Central and Eastern Europe than most regions. Until the early autumn of 2008, analysts were still listing reasons why the EU's new member-states would remain relatively resilient: sound macro-economic management, membership in the EU and (for some) in the euro, solid, low-cost manufacturing sectors, and financial systems that had focused on the basic business of lending to consumers and companies. 'Decoupling' remained a fashionable theory in Eastern Europe well into the second half of 2008. However, in August and September bad news started to trickle in. By October, Hungary had to call in the IMF to avert a currency crisis. Latvia quickly followed. Bulgaria, Lithuania and Romania may yet require help. (Outside the EU, the IMF had to assist Belarus, the Kyrgyz Republic, Serbia and Ukraine but this paper will focus on those Central and East European countries that are EU members.)

The severity with which the global financial and economic crisis hit many Central and East European (CEE) countries took most people by surprise. Until mid-2008, investors assumed that these fast-growing countries were firmly on a 'convergence' path towards West European income levels. Policy-makers from Tallinn to Bucharest were struggling with the consequences of economic overheating: rising inflation, asset bubbles and strengthening currencies. Within a matter of weeks, the focus shifted towards preventing currencies from collapsing and mitigating the ferocity of the economic downturn. The region's economies are, of course, very different. But since late 2008, there has been a strong perception that 'Eastern Europe' as a whole is in deep trouble.

Like everywhere else in the world, policy-makers, economists and businesspeople in this region have become obsessed with the question of how bad it is going to get. The outlook has been darkening quickly. At a Euromoney conference in Vienna in January, several East European central bank governors refused to discuss their governments' official forecast because they were "more than a month old" and hence

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"useless". Every new forecast is bleaker than the previous one. Private sector economists now predict recessions for almost all the EU's new member-states.

There is little doubt that 2009 will be dreadful and 2010 at best disappointing for CEE economies. Perhaps the more interesting question is what kind of decisions the governments in this region are likely to take during the downturn, and what these will mean for the medium- to long-term growth prospects of this region.

Despite the outbreak of riots in some of the new member-states, the risk of political turmoil or social upheaval should not be exaggerated. Policy procrastination is a bigger risk than political mayhem. Structural reforms in most of the new member-states had slowed already. The risk is now that they will grind to a halt while politicians focus on coping with the economic crisis and preparing for the elections that are scheduled in most of the new member-states over the next couple of years. Since the crisis does not alter the reform challenges – all CEE countries must quickly prepare for population ageing and move towards a greener and more knowledge-based economic model – this bodes ill for the region's medium- to long-term outlook.

Fire-fighting

Not all the new EU members have been affected equally by the economic downturn. The Polish economy grew fast for most of 2008, while those of Hungary and the Baltic states started slowing in 2007. Some new member-states entered the crisis with sounder economic fundamentals than others. Hungary's budget deficit in 2008 was almost 2.5 times bigger than Slovakia's (as a share of GDP). Bulgaria's foreign debt was around 90 per cent of GDP that year, for Poland the share was half that.

Nevertheless, across the region, economic indicators started to head south in the third quarter of last year, and by the fourth the numbers were looking truly dreadful. In November 2008 (the latest month for which figures were available at the time of writing), industrial output was down by 9, 12 and 17 per cent year on year in Poland, Slovenia and the Czech Republic, respectively. Since then export orders have collapsed and many of the region's big car producers have idled their plants for extended periods. The gas stoppages in January, which forced several CEE countries to shut down factories temporarily, have made matters worse.

Investment, which had been rising at double-digit rates in most new member-states, has plummeted, due to credit constraints, falling outside investment and the worsening economic outlook. Faced with rising unemployment, the spectre of falling wages and a sudden drying up of consumer credit, East Europeans have started to tighten their belts. While retails sales were still growing in Poland, Romania and Slovakia in November 2008, they fell steeply in the Baltic states and the Czech Republic.

Policy-makers in the new member-states were initially slow to react. In those countries where currencies came under pressure they rushed to restore confidence and seek outside aid. But unlike in Western Europe, there have so far been no major banking crises (with the exception of Latvia where the biggest local bank had to be nationalised). Nor have the CEE countries jumped on the Keynesian bandwagon, at least not yet. Most of them have put together some kind of stimulus package. But these have consisted mostly of already planned tax-cuts and investments. Instead, the new members hope to rely on accelerated spending of regional aid from Brussels. After a slow start, the disbursement of EU money is now proceeding more swiftly in the new members, and the Commission has loosened the rules a bit in the crisis. Nevertheless, the use of EU 'structural funds' is bureaucratic and slow – it has to be, to prevent fraud and waste. So it is questionable whether these funds are a suitable instrument for providing a short-term demand stimulus.

Those countries that can afford to, notably the Czech and Slovak Republics and Slovenia, will increase discretionary spending and cut taxes further. IMF/EU emergency programmes will oblige Hungary and Latvia to cut spending, not increase it. Lithuania, Bulgaria and Romania will have to reduce spending in an attempt to avoid having to call in the IMF. The Polish government has so far rejected any suggestion that it should spend its way out of trouble, not least since a fiscal splurge would destroy the credibility of the government's plan to join the euro in 2012. However, even if the new members decided to enact massive fiscal stimulus programmes, they could not compensate for the collapse in external demand, given how dependent their economies are on export markets. Any additional spending therefore needs to be targeted carefully on things that help future competitiveness, like infrastructure and education.

The bright spot in this gloomy picture is that falling inflation will give central banks in the big CEE countries room for monetary easing (Slovenia and Slovakia are in the eurozone while the Baltic states operate currency boards that leave them no room for an independent monetary policy). Lower global commodity prices, and in particular oil, decelerating domestic demand and rising unemployment will continue to erode inflationary pressures. But the inflation outlook will very much depend on whether the CEE currencies hold firm. Currency depreciation makes imports more expensive and pushes prices up. What is more, in countries, such as Latvia, Hungary and Poland up to 90 per cent of all mortgages and consumer loans, as well as a big chunk of corporate loans, had been taken out in euros, Swiss francs and even Japanese Yen in recent years. Any depreciation of the local currency immediately results in higher debt servicing costs. Currency risk then turns into credit risk. So if pressure on currencies resumed, central banks would have little choice but to hike interest rates again.

The secret of their success

Policy-makers around the world are struggling to gauge the severity of the crisis. Many face the fiendishly difficult task of repairing the damage from past excesses without plunging their economies into even deeper recessions. All are desperately looking for ways of stimulating demand in a way that also helps future growth. In the EU's new members, policy-makers are grappling with an additional source of confusion: the paradigm that has guided reform since the 1990s suddenly looks seriously flawed. The main drivers of growth over the last 15 years appear to have turned into impediments, or at least risks, to future performance. These drivers were: openness to trade and integration into pan-European supply chains; integration into international capital markets; and ambitious economic reform programmes, largely guided by the EU accession process.

Exports have been key to the economic success of this region. The foreign sales of all the new member-states have at least doubled in the last five years (in dollar terms). In the Czech Republic, Hungary and Slovakia, exports account for 80-90 per cent of GDP. Only in Poland is the share much lower, at just over 40 per cent. By contrast, in the UK economy (generally considered very open to the world), exports make up 30 per cent of GDP. By far the biggest market for all CEE is the eurozone, which is now in recession.

However, these countries have not only abolished barriers to trade and adopted the single market *acquis* to make it easier for foreign companies to set up shop. Their integration with the outside world goes much deeper: CEE countries have become part of pan-European, and in some cases global, supply chains. They import components and export finished goods. Or they make components, such as engines, for assembly elsewhere. The two most integrated sectors are consumer electronics and cars – two highly cyclical industries.

Car production in the CEE region doubled between 2000 and 2007, as the likes of Volkswagen, Fiat, Peugeot and KIA shifted manufacturing there. By 2008, transport equipment accounted for up to 50 per cent of all exports from CEE countries and 10 per cent of all value added (more in Slovakia). In theory, these countries could benefit from the current crisis in the global car sector. In a desperate attempt to cut costs, western car companies could relocate production to where labour is cheaper: wages in the new member-states are still only 20-40 per cent of those in Western Europe. Instead, the new member-states may become major losers from the subsidy race that is now under way. The big EU countries (as well as the US) are spending billions on their car companies with the expectation that jobs are maintained at home.

Another strength of the growth model in Central and Eastern Europe has been its deep integration into global capital markets. These countries have thrived by importing capital – and know-how – from the West. Until 2007, current account deficits in Central and Eastern Europe were comfortably funded through long-term foreign direct investment (FDI). With such sound financing, even very large external deficits appeared sustainable: in 2007, current account deficits reached 6 per cent in Hungary, 14 per cent in Romania and 23 per cent in Bulgaria. In the past, economists started worrying about a balance of payments crisis when a deficit reached 5 per cent of GDP.

By 2008, Eastern Europe's external deficits were only half financed by FDI, and they had become more dependent on shorter-term funding. When this funding dried up, some countries had to rely on emergency loans from the IMF and the EU. The days of safe long-term financing will not return soon. FDI to the region will fall considerably from its $160 billion peak in 2007. Other financial flows will contract even more.

Borrowing in international capital markets will be tough. CEE governments started cancelling international bond issues in the autumn of 2008 when capital markets dried up. In 2009 emerging markets are likely to be crowded out by massively higher borrowing from rich OECD economies: the US and West European governments alone are expected to issue $3 trillion in bonds this year. As such demand hits a thin market, lesser-rated borrowers, like most of the CEE states, will have to pay a very high price for borrowing money.

Bank lending will not provide a viable alternative either. Banking sectors in the new member-states are to a very large degree controlled by Austrian, Belgian, German, Italian, French, Greek and Swedish banks. These banks have helped to finance the lending activities of their CEE subsidiaries which, in turn, had to rely less on international capital markets to raise money. Initially, this looked like a blessing when these markets froze in 2008. However, many of the West European parent banks themselves are now seriously short of cash which translates into a lot less money for their subsidiaries – and for on-lending to CEE businesses and consumers.

The role of the EU

The post-Cold War CEE growth model looks broken. Another guiding principle for economic policy-making – EU membership – has started to look shaky too. Since the early 1990s, governments in the region have justified many painful changes by the need to get ready for EU membership. Perhaps not surprisingly, the pace of reform has slowed noticeably since 2004 when eight East European countries joined the club (Bulgaria and Romania were so sure they would follow in 2007 that they relaxed as well). Generally, the EU has a lot more leverage over countries that are still queuing outside the Union than those that sit at the Brussels table where decisions are made. The economic crisis will make it harder still for the EU to tell the new member-states what to do.

Germany, the UK and the other big EU countries are now nationalising some of their banks, propping up industries and stretching EU budget rules. The state is making a comeback everywhere. Trouble is that governments in Central and Eastern Europe are often weak, and sometimes prone to populism, incompetence and corruption. The new members need an external anchor more than the richer, West European countries. But the Commission's authority as a reform watchdog is diminished. The 'Lisbon' reform agenda – designed to encourage EU member-states to liberalise and modernise their economies – seems almost entirely forgotten. The legal framework for the single market is under threat of being weakened. Already, the Commission has had to loosen competition and state aid rules to allow for industry bail-outs and emergency bank mergers. It will take years to strengthen the rules again. Since local laws and institutions are weaker in the new members than in many West European countries, this matters.

Nor will the objective of joining the euro provide much motivation for reform in the new member-states. The criteria that a country needs to fulfil for eurozone entry relate to inflation, interest rates and public finances. The sorry state of some eurozone economies shows that adopting the single currency does not necessarily entice a country to go for deeper reforms, such as making labour markets more flexible.

The economic crisis has made many new members keener to join the euro. While having their currencies battered in the markets, Poles and Hungarians looked with envy at Slovenia and Slovakia, which joined the eurozone in January 2007 and January 2009, respectively. The euro now looks like a safe haven, particularly for those countries that teeter on a pile of foreign currency denominated loans.

However, the crisis will also make it more difficult for countries to comply with the 'Maastricht' criteria for euro entry. In particular, keeping the budget deficit below 3 per cent of GDP will be much harder in a recession when tax receipts fall and spending balloons. For this reason, most analysts think that Poland's target to join the single currency in 2012 is unrealistic. Hungary and the Czech Republic are keeping their options open. The Baltic states would like to join as quickly as possible since their currency boards (and in the case of Latvia, a strict euro-peg that is very similar to a currency board) could leave them in the worst of both worlds: denied the chance of devaluing, while subject to the risk of a balance of payments crisis.

The ECB, the Commission and various eurozone governments will insist on strict fulfilment of the Maastricht criteria, as they have done in the past. Lithuanians were very upset in 2006, when their euro application was rejected because they missed the inflation criteria by the tiniest of margins. This robust stance on the euro will not endear the EU to those East Europeans who are longing for the stability of eurozone membership.

There are other reasons too why people in the new members may become disillusioned with the EU. One reason could be a perceived lack of EU 'solidarity'. Solidarity has become an important yardstick for the people in Central and Eastern Europe and the Baltic states. They often feel that the big EU countries do not pay sufficient attention to their concerns, for example about Russian bullying of neighbouring states or the costs of meeting EU climate change targets in poorer countries. Since the onset of the economic crisis, some of the new members have complained that EU rescue efforts have focused too heavily on the richer eurozone countries and those with big banking sectors. Zsolt Darvas and Jean-Pisani-Ferry, from the Bruegel think-tank, warned in a December note that the EU must take more specific action to help the new members, to avoid the emergence of "a new European divide".

But the EU has already done quite a lot to support CEE countries in trouble. The European Commission quickly raised money to contribute to the emergency loan packages for Hungary and Latvia (€6.5 billion and €3.1 billion, respectively). It is now said to be talking about a possible emergency loan to Romania (probably again with IMF involvement). Individual EU governments, for example the Swedish and Czech ones, have contributed money to these emergency packages. The ECB has provided short-term 'swap' facilities to make euros available for Hungary and Poland (together with the Swiss central bank, since many loans in these countries are denominated in Swiss francs). The EU has also frontloaded some of the money allocated for the new members in its budget and it has loosened its rules for regional aid spending a little to speed things up.

The banking nexus

However, the big test for EU solidarity may yet come, namely through the banking sector. If companies in Slovakia, Poland or Hungary are seen to be going bankrupt because West European parent banks cut off the flow of loans, many East Europeans will question the wisdom of selling their banks and opening up their capital markets. They will request help from those countries where the parent banks are located. However, governments that use large amounts of taxpayers' money to prop up their own banks usually want them to use that money to lend to domestic businesses and consumers, not help foreign subsidiaries.

Already, people in the new member-states are grumbling that West European banks are exacerbating their economic situation by cutting credit lines. Some also worry that if a parent bank got into serious trouble it could withdraw capital from its East European subsidiaries to patch up holes at home or that it may have to fire-sell these subsidiaries or – if no buyer steps forward – let them fail. Such steps would cause further financial instability in the CEE countries, where the share of non-performing loans is already creeping up.

Banking trouble in the new members would spill back into the old EU. The assets that Austrian banks hold in CEE countries amount to over 60 per cent of Austrian GDP. The CEE assets of banks in Sweden and Belgium amount to 20 per cent of their respective GDPs, while for Italy and Greece the share is around 10 per cent. Economists at Goldman Sachs have estimated the losses that would ensue if East European banks needed to be recapitalised. For Austria, the losses could amount to 1.6-5.5 per cent of GDP, depending on the severity of the crisis. For Belgium and Sweden, they could be 0.6-2 per cent of GDP. This is why a group of West European banks with big stakes in Eastern Europe has asked the EU and the ECB to stand ready to help in case of bank failures in the new member-states (as well as non-EU countries in Eastern Europe).

Political backlash or wasted opportunity?

Even if banking crises in the new member-states can be avoided, there is no doubt that external financing will be very hard to come by in 2009 and possibly beyond. This means that external deficits in many of the new member-states will have to shrink considerably. Since exports will fall, imports (and domestic demand) will have to fall even faster. This will come as a nasty surprise to the people in Central and Eastern Europe.

Riots broke out in January in Bulgaria, Latvia and Lithuania. In the other new member-states, workers have grumbled but not gone on wild-cat strikes or mass demonstrations, like in the UK or France. Some observers nevertheless predict that the economic crisis will lead to social unrest and cause an anti-capitalist backlash in Central and Eastern Europe. Some even suggest that political instability may allow Russia to meddle in its former satellite countries. Such fears are probably overblown.

Politics in the Baltic states and in Central and Eastern Europe has always been fractious, noisy and prone to scandal. People across the region have a strong tendency to throw out their government at the earliest possible opportunity. In the year after accession in 2004, every single one of the new member-states saw its government fall. Populist forces have grabbed power in CEE countries from time to time in the past – without, however, doing much lasting damage. Slovakia's ruling coalition of populists and nationalists has not rescinded reforms. Poland's eccentric Kaczynski government lasted only one term.

Nevertheless, an increase in political infighting and a lot of high-pitched populist rhetoric are likely to accompany the downturn. Many people in Central and Eastern Europe have become used to double-digit wage growth, rising living standards and increased job security. Having left the pain of the post-transition downturns behind, it seemed that the only way for their economies to go was up. EU entry appeared to deliver what it had promised: prosperity and stability. Most people cared little about politics as long as growth was strong. It is not clear how people in these countries will react to mass lay-offs, shrinking pay packages and, in some countries, the curtailment of state benefits. The return of laid-off migrant workers from Western Europe could add to local discontent in some places.

The June 2009 elections to the European Parliament will provide an early opportunity to measure the political temperature. The results cannot easily be projected onto the general elections scheduled in most of the new member-states in 2010-11: turnout in EP elections is shockingly low in many new member-states, and voters are tempted to vote for more extreme parties, feeling that their choices matter less. But a big rise in support for radical and populist forces would make those CEE governments that face elections in 2010-11 even more cautious about implementing any kind of unpopular measures.

In short, the risk is not so much that political turmoil will engulf the region but that frightened and distracted governments put structural reforms on hold. At least some people in the region will question whether the economic path their countries have been on since the early 1990s – economic liberalisation and integration with the EU – was the right one. True, EU membership and the need to attract external financing in a much tougher environment will prevent CEE governments from rolling back reforms on a grand scale. But in terms of preparing for globalisation, ageing and environmental sustainability, the next couple of years could be wasted.

This would be worrying. Irrespective of the crisis, the medium-term reform challenges for the CEE states remain the same, from streamlining social security systems to spending more on research and development and moving to a low-carbon economy. In some ways, such structural reforms are even more urgent now. This is a region that has always been acutely aware that it is competing with Asian and other emerging markets for foreign investment and global markets. In a world where liquidity has dried up and most rich countries are in recession, competition for investment and export markets will be even fiercer.

There are at least two other reasons why the next couple of years will be critical for the region's long-term outlook. One is that populations are already ageing fast. The World Bank calculates there will be 18 per cent fewer Bulgarians in 2025 than there were in 2000. The number of Hungarians is forecast to fall by 13 per cent over the same period, while the Czech Republic, Poland and Slovakia can expect population shrinkage of 3-5 per cent. In many of the new member-states, one in five people will be over 65 by 2025 and the median age will approach 50. The shrinking of CEE workforces is inevitable, but the economic consequences will very much depend on whether these countries manage to raise employment rates, boost productivity and put their pension and healthcare systems onto a sustainable footing.

Another reason why the new member-states need fast reform is that that they are at the threshold of moving from a manufacturing to a knowledge economy. Already, labour productivity in the CEE countries has reached almost 50 per cent of that in the US, according to the EBRD. For further catch-up to occur, these countries need to rely less on importing technology from elsewhere and more on innovating themselves. Wedged between a high-tech Western Europe and a low-cost East, there is only one way to go for the CEE states if they want to continue growing richer: move up the value chain. The crisis has added another imperative: diversify away from highly cyclical industries such as cars. Such economic upgrading requires investing lots in education and retraining, encouraging competition, innovation and entrepreneurship, and improving the business environment.

The Baltic countries rank among the top 30 in the World Bank's 'ease of doing business' survey, with Slovakia and Hungary not that far behind. But the Czech Republic and Poland are way down the list, somewhere between Tunisia and Pakistan. For countries that aspire to catch up with West European income levels, this is clearly not good enough. However, for the first time since the onset of transition, the Economist Intelligence Unit's 'business environment forecasts' predict no improvements in CEE business environments over the next five years.

Education reform is also crucial. There has been some progress in all the new member-states. International studies, such as the OECD's PISA tests, show that most CEE states do well at the level of secondary education. Czech, Estonian and Hungarian youngsters score as high or higher than those from much richer countries in maths, reading and science. But those from other countries in the region fare less well. And trouble is brewing at the tertiary level. University systems tend to be starved of cash and shackled by bureaucracy and out-of-date curricula.

In Bulgaria, Poland and Romania, one in five people under 25 is unemployed – due to a mixture of inadequate skills and rigid labour markets. This means that a large part of tomorrow's workforce is not currently in education or picking up useful skills on the job. A report from the Lisbon Council, a think tank, warned in 2007 that unless countries such as Bulgarian and Poland rapidly improve their skills-base, they could remain stuck in relative poverty: no other resource but human capital can lift them out of the situation they are in today.

A new growth model?

The new member-states will not escape the global economic crisis. Some are already in deep recession, while in most others growth is coming to a screeching halt after years of fast expansion. For most people, the next two years will be the most difficult since the start of the transition from central planning to a market economy. Back in the early 1990s, the joy of freedom, hopes for rapidly improving living standards and the wish to join the EU made economic pain look bearable. Today, the risk of rising discontent is perhaps greater. Even if the violent demonstrations seen in Latvia, Lithuania and Bulgaria in early 2009 are not repeated, politicians across the region will be tempted to go down the populist route. Most governments can ill afford to spend their way out of trouble but they could seek to placate their electorates by putting structural reforms on hold, or even unwinding some of the privatisations, social security and labour market reforms already achieved. The European Union is no longer the anchor it once was, and the West European countries are in a poor position to preach since they are themselves putting reforms on hold and bailing out their industries.

Politicians in the new member-states must resist the temptation to discard their post-Cold War growth model entirely. Yes, the integration and liberalisation of the 1990s and early 2000s has left their countries vulnerable to the double-whammy of credit crunch and collapsing export markets. But the new members can also boast many strong features: public debt tends to be low; most youngsters get a solid education that is adequate for excelling in manufacturing; the tax burden tends to be low for businesses (though high for workers); markets are generally open and deeply integrated into the EU's 13 trillion single market; and, perhaps most importantly, people in the new member-states are used to fast change.

The challenge for East European policy-makers is to change and improve the 1990s growth model in a way that prepares their countries for fiercer global competition, ageing workforces and stricter climate change targets. They need to encourage the upgrading and diversification of their industries; build up well-regulated, high-quality service sectors (and yes, finance is one of them); invest in new infrastructure and greener technologies; streamline their social security systems; and improve education and training. They do not have much time to waste if they want to continue catching up with West European income levels.

The EU has shown its support for the new member-states through providing emergency finance and making it a little easier to use EU budget money. There is more that the EU can do to help the CEE countries navigate through the difficult period ahead. More aid may be needed for Romania and other countries that look fragile. This aid should not only go towards bolstering foreign exchange reserves but also helping companies, for example through export credits or tax cuts. An emergency plan needs to be in place in case West European banking failures threaten to destabilise East European financial systems. The big stakes that West European banks have in the new-member states make cross-border banking supervision more urgent. The EU should think again whether the Maastricht criteria really are the best way of measuring a country's readiness for the single currency. East European policy-makers have been too complacent about ballooning external deficits and dizzying credit growth in the economies. But the EU may want to reflect on how to strengthen its system of macro-economic surveyance.

The richer EU member-states must be careful not to allow any weakening of the EU's single market framework and they should not forget the Lisbon agenda of modernisation and reform – these things matter to Eastern Europe. And they must refrain from blaming 'cheap' East European workers for rising unemployment, or exploit other protectionist pressures that will mount during the recession. The immediate stability of the whole EU would be at risk in case of financial collapse, social unrest or political extremism in the new member-states. The medium-term consequences could be more costly still. If the crisis is handled badly in Central and Eastern Europe, the region could emerge with its growth prospects impaired, its politicians eurosceptic and its workers packing up to move west.

Snapshots from selected new member-states

Czech Republic

The Czech economy has been doing a bit better than those of its neighbours. It is much less reliant on external finance. The lending of Czech banks has been based on primary deposits, not foreign borrowing. Since domestic interest rates have been very low for quite some time, Czech consumers and companies have not been tempted to borrow in foreign currency. Export orders will drop, like everywhere else. But since the Czech Republic entered the crisis with only a tiny current-account deficit, it can afford to boost domestic demand without hitting an external financing constraint.

Despite their rosier economic outlook, the Czechs are no more likely to speed up economic reform than any of their neighbours. The centre-right coalition government has been weakened by divisions, which were exacerbated by its heavy losses in the local and Senate elections in October 2008. In the first half of 2009, the EU presidency will require the government's full attention. Beyond that, there are doubts whether the coalition will hold together. The ODS, the biggest party in the coalition, is itself plagued by internal splits. Moreover, although the president has limited formal powers, the eurosceptic Vaclav Klaus sometimes saps the government's energy through futile political battles. The opposition Social Democrats are now forming coalitions with the (largely unreformed) Communists at the local level. If the Social Democrats did well in the 2010 parliamentary election, the spectre of a broader co-operation with the Communists would unsettle investors.

Hungary

Until the autumn of 2008 it looked unlikely that the Socialist minority government under Ferenc Gyurcsany would see out the reminder of its term. But as things got worse, Hungarians rallied around their government, and a leadership contest within the Socialist party also looks less likely. However, the austerity measures required to fulfil the IMF programme will invariably dent the government's popularity, and Fidesz, the main opposition party, continues to lead in the polls. Gyurcsany may not want to overload his political agenda further by adding structural reforms to the tightening of macro-economic policy required by the IMF.

Financial conditions have eased since Hungary received its massive €25 billion IMF/EU rescue package in October. The central bank has been able to cut rates gradually, after hiking them to 11.5 per cent in October in an effort to defend the forint. But most analysts expect rates to stay at around 8 per cent for much of 2009. With inflation expected to come down to 3 per cent, that still means real interest rates that are punishingly high. Investment will therefore not recover until 2010 at the earliest. And with no other drivers of growth available, the recession will be deep and protracted. Hungary will have to attract almost $5 billion to finance its current-account deficit in 2009, as well as rolling over $15 billion in debt due this year.

Latvia

Tiny Latvia (population 2.3 million) was heading for a fall well before western financial systems collapsed. Growth rates of over 10 per cent in recent years were clearly unsustainable. A current-account deficit of more than 20 per cent of GDP in both 2006 and 2007 was a clear sign of trouble brewing. By October 2008, the currency's peg to the euro could only be maintained with a massive (compared with Latvian GDP) €10 billion IMF-led emergency package. The government has committed itself to cutting public sector wages by 20 per cent in 2009, which, with inflation still in the double digits, means real wages cuts of 30-35 per cent. Latvia's economy was already in deep recession in the second half of 2008, and will most likely contract by 8-10 per cent in 2009.

Latvians have long become fed up with their political class. Corruption scandals and political infighting have brought down one government after the other. After a 10,000-strong street rally in Riga turned violent in January, the president presented the prime minister with a stark choice: change the constitution or face early elections in March. Few people now expect the unpopular four-party government to limp through until October 2010, the next scheduled election date. Many hope that a new, broader coalition will be better able both to withstand mounting discontent over the economy and to put Latvia's economy on a more sustainable growth path.

Poland

Until the end of 2008, the Polish government's official forecast was for 3.7 per cent growth in 2009, and even private sector forecasters still expected around 2 per cent. Since then, a string of bad numbers has led to further downward revisions, with many now saying that Poland will be lucky to avoid a recession. Poland's strength is the size of its domestic market, which makes it a lot less dependent on exports. Also, its industrial base is more diversified and less reliant on the car industry. Perhaps more than other new member-states, Poland could benefit from the return of highly skilled workers and from infrastructure investments co-financed by structural funds (given that the need for infrastructure improvements is much bigger than in, say, Hungary or the Czech Republic).

But while the economic outlook is a little better than elsewhere in the short-term, Poland could be storing up trouble in the medium term. The very fact that it is less dependent on the outside world makes it easier for Poland to make policy mistakes and to procrastinate. The centre-right coalition headed by Donald Tusk had promised to shift the focus away from the political witch hunts that had characterised the Kaczynski government. However, while Tusk has managed to heal some internal divisions and reconcile Poland with Germany and the EU, it has done little to promote economic reform. This is unlikely to change now, not least because Tusk has his eyes on the presidency in the 2010 election. He will be loath to further alienate potential voters at a time when unemployment is once again creeping above the 10 per cent threshold. Even if Tusk became more determined to push through structural reforms, there is always the risk that President Kaczynski will veto them.

Romania

Recent elections in November 2008 produced a three-party coalition government with a solid parliamentary majority and – unusually – the backing of the president. Although the economy slowed noticeably towards the end of 2008, full-year GDP growth was still almost 8 per cent. Exports are more diversified and less concentrated in cyclical goods than in other CEE countries. Public debt is less than 10 per cent of GDP. This is where the good news ends.

Romania's gaping external deficit (around 13 per cent of GDP in both 2007 and 2008) leaves the country extremely vulnerable. Its government bonds were downgraded to 'junk' status at the end of 2008. The currency fell 20 per cent against the euro from October 2008 to January 2009, and more downward pressure is inevitable – as is an economic recession as the government struggles to bring the fiscal deficit under control. Frustration over the economy could add to existing political disillusionment and bring about an early election. In the last one, less than 40 per cent of Romanians bothered to vote. In January, a former prime minister was indicted on corruption charges – the first high-profile prosecution after years of government foot-dragging despite mounting EU pressure. Even assuming the authorities were determined, cleaning up Romanian politics would take many years: in Transparency International's corruption perception index, the country ranks on par with Columbia and just ahead of China.

Slovakia

Until recently, Slovakia was the poster boy of the CEE region, with growth rates of 10 per cent in 2007 and 7 per cent even in 2008. However, Slovakia's reliance on the car industry (which accounts for 20 per cent of GDP) means that exports will suffer a lot in 2009 while investment (largely financed by FDI) will decelerate drastically. Nevertheless, many economists still expect Slovakia to avoid an outright recession.

The scope for populism is probably higher in Slovakia than elsewhere. The coalition led by the populist Smer party (which also includes arch-conservatives and ultra-nationalists) may break apart before its mandate expires in 2010. Another risk is that the government could try to deflect attention from the economic troubles by rekindling tensions with neighbouring Hungary. In theory, euro membership should provide the country with a degree of outside stability, at least by insulating it against the risk of a current-account crisis. However, as the experience of Greece, Italy and Portugal has revealed, euro membership as such does not spur a country into reforming its economy. And the cases of Ireland and Spain show that members of the single currency can build up substantial macro-economic imbalances. So a responsible government is as important within the eurozone as outside.

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