

The Global Financial Crisis: Eastern Europe and CIS Hit Hard

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Eastern European and Commonwealth of Independent State (CIS) countries (excluding Russia) have been generally badly affected by the global financial crisis and economic downturn 2008.

The impact on growth has varied but weak demand for commodities and exports, as well as the drying-up of international liquidity is having repercussions. As elsewhere in the world, businesses and consumers face challenging times.

Key points

Eastern European and Central Asian states have enjoyed rapid growth in recent years, fuelled by high foreign investment and strong commodity prices. However, the financial and credit crisis, which erupted in autumn 2007 and threatens a global recession, has affected these regions to varying degrees;

Eastern European real GDP growth is expected to fall from 5.7% in 2007 to 4.2% in 2008 and 2.5% in 2009, according to IMF November 2008 estimates, which had been repeatedly downgraded over 2008. The worst-affected countries will be those dependent on the eurozone for investment and export markets, while new EU entrants, Bulgaria and Romania, are also at risk from large current account deficits;

CIS countries excluding Russia are set to experience the most drastic fall of all regions. According to IMF figures, real GDP growth will plummet from 9.8% in 2007 to 6.9% in 2008 and 1.6% in 2009. Previous IMF figures had projected growth in CIS countries to be 6.2% in 2009, indicating the severe deterioration in October-November 2008;

Although most financial institutions in both regions suffered no major direct exposure to US credit markets, they have seen an outward flight of capital in the wake of the financial crisis as liquidity dried up. Western European banks in particular had close links with Eastern European institutions;

Property market bubbles have popped in Eastern Europe, especially Baltic states such as Latvia and Lithuania, where speculation and foreign investment had fuelled rapid but unsustainable growth in house prices;

CIS countries have been particularly affected by commodity prices, which have fallen as a result of slowing global demand. Ukraine, for instance, is highly dependent on steel. Similarly, oil-rich central Asian countries such as Kazakhstan will be affected in a similar way;

Current account deficits are expected to remain high for many countries in these regions in 2008 as governments struggle with lower tax revenues and demands for state support in the most-affected industries. For example, Bulgaria's current account deficit is expected to reach -24.4% of GDP in 2008 owing to strong imports;

Business failures, lower FDI, falling consumer incomes and higher unemployment are likely to be amongst the main effects on these economies in 2009. However, there may be some benefits from the slowdown, notably a sharp decrease in inflation, which should ease pressure on consumers, and only a small number of countries will actually go into recession.

Background

The Eastern European and CIS regions are extremely diverse:

It ranges from new EU members such as Bulgaria to isolated Central Asian states such as Turkmenistan. Both regions have experienced strong growth at 9.8% for the CIS countries in 2007 excluding Russia and 5.7% for Eastern Europe. A chief driver of growth has been a boom commodities and construction. At a regional level, however, the CIS is expected to see a sharper downturn than Eastern Europe;

Regional growth in the CIS excluding Russia is expected to fall to 6.9% in 2008 and 1.6% in 2009, according to IMF November 2008 forecasts. The main reason is sharply declining global demand for commodities, particularly oil and metals, on which many CIS countries rely;

The downturn in Eastern Europe is expected to be closer in line with global growth patterns. Real GDP growth is set to fall from 5.7% in 2007 to 4.2% in 2008 and 2.5% in 2009. This reflects the comparatively more developed global trade and financial links in this region, which has helped to drive growth along with tourism, rising incomes and higher domestic demand.

Financial fallout

Few financial institutions in Eastern Europe and the CIS were directly affected by the US sub-prime mortgage crisis, thanks to their comparatively small exposure to overseas assets. However, financial institutions are far from immune:

Many Eastern European banks relied on credit from Western European banks, which often owned significant stakes in financial institutions. Amongst the most vulnerable countries in this regard were Estonia, Ukraine, Croatia and Latvia, where the drying-up of capital from parent institutions has severely affected businesses and consumers;

Similarly, banks in Kazakhstan (Central Asia's largest economy) were thought to be particularly badly affected as they borrowed heavily from foreign institutions, including those in the USA, and were over-exposed to the domestic construction sector which is now experiencing a sharp downturn;

The situation was arguably most severe in Hungary and Ukraine, which received emergency loans from the IMF in October 2008 at US\$15.7 billion and US\$16.5 billion respectively. This was in order to stave off crises in the banking industry and stabilise the financial sector, with Hungary also affected by a large budget deficit and slowing growth, and Ukraine hit by a depreciating currency, tumbling stockmarket and political disagreement;

Central Asian countries look to be better insulated than Eastern European countries. For instance, windfall oil revenues had allowed Kazakhstan to build up estimated foreign exchange reserves of US\$16.8 billion in 2008, and in October 2008 the government announced it would spend US\$5 billion to recapitalise struggling banks;

Turkmenistan and Uzbekistan, two of the least developed countries in the region, have been better insulated due to their weaker international financial and trade links, but still may be more affected than initially thought;

The state of current accounts in the region is mixed for 2008. While some oil producers such as Azerbaijan (38.3% of GDP), Turkmenistan (26.5% of GDP) and Uzbekistan (16.8% of GDP) are in a relatively strong position, others such as Georgia (-20.8% of GDP) or Moldova (-19.9% of GDP) are more vulnerable due to higher levels of spending and limited government income.

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Impacts on the real economy

While the effects vary from country to country, the most significant impact in these regions will be on consumers and businesses in the real economy:

Weakening demand from key export markets in Western Europe will reduce demand for Eastern European goods. For instance, in 2007 the Czech Republic sent 52.6% of its exports to the EU-27, with the equivalent figure being 50.4% in Hungary and 53.5% in Poland. Ukraine also relied on commodity exports, particularly steel, whose value plunged in the second half of 2008 thanks to falling global demand;

The property sector has been badly affected, particularly in Baltic States such as Latvia or Estonia but also in Ukraine and other countries which had seen speculation from foreign investors and high levels of credit. Prices are falling rapidly, meaning that individual and institutional investors may face losses in cities such as Riga, for example;

Inward FDI into Eastern Europe and CIS countries is likely to fall sharply in 2008-2009, thanks to global economic conditions and a shortage of liquidity. This will create fewer jobs and less new business opportunities, as well as hinder intangible benefits such as knowledge transfer;

Unemployment is likely to rise around the region. It is already at high levels in countries such as Bosnia (47.0% in 2007) and is also thought to be high in central Asian countries where few reliable data are available. The commodity and construction sectors are likely to see major job losses, particularly in countries such as Ukraine and Kazakhstan.

Some benefits

While the short-term picture is gloomy, some positive points may emerge:

Inflation is likely to have fallen sharply in the second half of 2008-2009, in line with most other regions, thanks to falling commodity and food prices and easing demand. It had previously reached high levels and is projected to fall for instance from 25.3% to 18.8% over 2008-2009 in Ukraine, 12.2% to 7.0% in Bulgaria and from 11.3% to 6.2% in Lithuania;

Longer-term, the economies of these regions may be streamlined and consolidated as a result of the downturn. They may tighten regulation to better control credit extended by banks, while others may be prompted to encourage economic diversification away from a reliance on commodity exports;

Lastly, to put things in perspective, only a small number of countries in these regions expect to be in recession in 2008 or 2009, in contrast to Western Europe or the USA. Those most in danger of experiencing shrinking output include Latvia and Estonia, which entered technical recession in 2008 (two quarters of negative quarterly real GDP growth).

Future scenarios

The full impact on the real economies of Eastern European and CIS countries is only likely to be felt in 2009. The region as a whole will perform better than advanced economies (the eurozone is expected to contract by -0.5% in 2009) but not as strongly as Africa and the Middle East, where 2009 growth is set to be 4.7% and 5.3% respectively. Central and Eastern European real GDP growth is expected to reach 4.2% in 2008 and slow to 2.5% in 2009, while the CIS excluding Russia is expected to reach just 1.6% in 2009.

Global demand for commodities including oil is expected to slow in 2009 thanks to the economic downturn. This will have further negative effects on businesses and employees in countries such as Ukraine or Kazakhstan, which rely on commodity exports.

The price of oil is expected to fall further in 2009. Similarly, economic contractions in most Western European countries will curtail demand for exports in Eastern European countries and weigh upon current accounts in most countries.

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