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POST-SOCIALIST ECONOMIC REFORM IN CENTRAL AND EASTERN EUROPE AND ITS IMPLICATIONS FOR ECONOMIC RECOVERY AFTER THE GLOBAL FINANCIAL CRISIS OF 2008

Most consider the declared bankruptcy of Lehman Brothers Holdings Inc. on September 15, 2008 as the official start of the global financial crisis 2008-2010. Soon after, capital markets across the globe began to freeze up and consumer confidence plummeted to severely damaging levels. Given the advanced inter-connectedness of the global economy, no country or people was unaffected by this apparent failure of free-market capitalism. Exuberance and poor lending standards throughout the banking world have been pinned by many as the culprits for the resulting global economic recession. This study is most concerned with the economic effects witnessed in Central and Eastern Europe (CEE) during this economic crisis as determined by the varying degrees of social, political, and economic reform since the dissolution of the Soviet Union in 1991. The research question of interest is to what extent have the post-socialist market reforms affected CEE nation states' recovery efforts following the global financial crisis of 2008. More specifically, it is to be determined if the post-socialist banking reforms of increased privatization and foreign investment in the CEE region exacerbated the economic downturn, with the assumption that Western bank subsidiaries hold a majority market share.

My research has shown that the economic outlook for the region as a whole remains positive with growth potentials outstripping developed world markets in the medium term, but individual state recovery will be determined by each state's post-socialist reforms, pre-crisis financial positioning, and domestic institutional maturity. Fear of prolonged capital withdrawal by foreign-owned banks has proved to be unfounded, as capital necessary for economic growth and recovery has begun to flow back into the region. Issues of European Union membership, foreign capital dependency, social and political cohesion, and trade liberalization have been unpacked to understand the impact the global financial crisis has had on the CEE region, as well as the forecast for recovery. The magnitude of economic ills suffered at the hands of the global financial crisis of 2008, and the levels of economic recovery, vary according to the degree of financial leverage by foreign-owned banking subsidiaries in CEE states and how willing CEE actors were willing to engage in easy lending, reliance on international trade and domestic market diversifications, and the social underpinnings affecting political and economic stability.

Following the demise of the socialist state in 1991, western multilaterals quickly rushed onto the scene to promote a transition to free-market policies. Much has been written about the successes and failures of the move to free-market capitalism throughout Eastern Europe and Central Asia. Most agreed that by adopting the proven economic system of the developed world and placing greater emphasis on the market was the best way forward and would promote the fastest transition to economic growth and

prosperity throughout the region. In so doing, the increased role of international capital and banking became a key policy agenda advocated by the West. CEE states were advised by international agencies such as the World Bank and International Monetary Fund (IMF) to pursue rapid banking sector privatization to help spur the necessary capital injection into their economies. "The reorganization of central banks in the early 1990s and the political goal of accession to the European Union (EU) that would entail monetary union meant that financial reform became synonymous with liberalization and integration with the West European banking sector" (Smith and Swain 2010: 13). By quickly privatizing the predominately state-owned banking sector, many states saw a swift take-over by foreign banking groups. As will been seen, the privatization of the domestic banking sector is not the culprit for the recent financial crisis, rather the ease of credit provided by poorly regulated private banks proved too tempting for several countries, resulting in over indebtedness and a capital crunch. This transition phase, however, was adamantly praised by the Western world as a painful, but necessary step toward democratic, free-market capitalism.

The speed of the transformation in Central and Eastern Europe has received both praise and blame for many of the resulting effects. Reasons for such rapid transition include the restoration of an established and proven system, the entrepreneurial spirit of the people, limited resistance, foreign influence, and modern technology. By assessing the situation from the perspective of great historical change, the post-socialist transformation can be considered a major success for the witnessed rise of democracy and human rights with marked economic growth, all of which took place in a peaceful and non-violent manner (Kornai 2008). However, not all consider the handling and effects of the transition to capitalism as progress or even positive. As figure 1.1 suggests, the CEE region, as represented by the eight countries identified, has seen improved economic growth following the transition to capitalism. In all but two cases, economic growth rates increased in the period following the dissolution of the Soviet Union. This, however, is counter-balanced by figure 1.2 and the evident rise in inequality, unemployment, and criminal activity in the post-socialist period.

Growth Rates - Before and After Transition
Figure 1.1

Country	1980-1989	1995-2003
Czech Republic	1.8	1.5
Estonia	3.2	5.5
Hungary	1.7	3.8
Latvia	4.2	5.6
Lithuania	4.9	4.7
Poland	1.1	4.0
Slovakia	1.8	4.2
Slovenia	0.1	3.8
CEE 8	1.7	3.6
EU 15		2.2

Source: Kornai, János; *The Great Transformation of Central Eastern Europe: Success and Disappointment*

By engaging in such rapid reform, many CEE economies were faced with serious problems otherwise avoided by gradual transformation. Denationalization and deregulation are important market reforms, but without complimentary domestic competition and mature institutions the economy can be left vulnerable and weak. For most CEE states, the dilemma for public officials was that "spending money on social safety nets could harm economic growth prospects later, but the failure to address the growing needs of the population might place the entire liberalization project in jeopardy (Kapstein 1997: 1433). The increase in the number of people depending on the state for income and lifestyle perseverance (dependency ratio) put pressure on governments to meet rising pension expenses, which cut into urgent expenditures on education, health care, and infrastructure development. The funding gap was then filled either through inflationary monetary expansion or by borrowing on capital markets, fueling inflation and

strengthening the crowding-out effect of private expenditure (Kolodko 2000: 180). On the whole, the policies in line with the 'Washington Consensus' did not initially result in forecasted growth prospects, as the decline in GDP in the first few years caused savings to shrink, hindering private investment and retarding growth (Kolodko 2000). Given these varying social, political, and economic effects, Kornai concludes that it is "both sensible and defensible to say that what has happened in this region can be simultaneously considered a success in terms of its global historical significance, *and* a failure in many important aspects because it caused pain, bitterness and disappointment for so many people" (2008: 32).

CEE 8 Key Statistics
Figure 1.2

Gini Coefficient

1987-1989	1996-1997	2001-2002
23.8	28.9	30.9

Unemployment (%)

1990	1992	1993	1996	1999	2002	2003
4.4	10.6	12.4	10.6	12.1	15.4	15.3

Crime Rate (1989 = 100)

1990	1994	1998	2002
156	194	228	249

Source: Kornai, János; *The Great Transformation of Central Eastern Europe: Success and Disappointment*

At the outset, the rapid inflow of Foreign Direct Investment (FDI) into the CEE region served as an important form of international support for CEE states as they transitioned from socialist to free-market economies. As soon as 1997, FDI accounted for 22.2 percent and 34.4 percent of Estonia and Hungary's GDPs respectively. For countries like Estonia, the internationalization of its banking sector and resulting high levels of FDI can be attributed to its highly skilled and relatively cheap labor, access to a stable business market, and its attractive geographic location with high growth potential (Sõrg, Kunka and Miljan 2002: 146-147). As CEE states opened their economies to foreign competition and engaged in high levels of deregulation to make investment opportunities more attractive, Western European investors did not hesitate to expand out of their saturated markets in search of greater gains throughout the CEE region, specifically in the banking sector. In Poland, large international institutions such as the U.S. Treasury, IMF, and EBRD lobbied against plans to retain state ownership in the banking sector in the early 1990s, resulting in the privatization of state-owned banks to Western European banking groups. As of March 2009, the proportion of foreign equity capital ownership in the Slovakian banking sector had increased from 12 percent (1993) to 91 percent (Smith and Swain 2010: 14-15). This high level of investment and ownership played an important role in moving CEE states toward free-market capitalism, but added a new level of dependence and vulnerability that would prove to be exacerbating in the face of an international financial crisis.

Vulnerability to the financial crisis of 2008 varied between CEE states. In Ukraine for example, the root cause of Ukraine's crisis was its exchange rate peg to the U.S. dollar that ended up attracting harmful short-term currency inflows, resulting in excessive cost levels (Åslund 2009). The large currency inflows boosted the money supply 40-50 percent year on year between 2002 and 2007, and inflation peaked at 31 percent in May 2008 (371-372). Upon the outbreak of the crisis in September 2008, it quickly became apparent that Ukraine would not be able to service its debt. Ukraine it was essentially cut off from international finance, and the depressed global economy now demanded less metal and steel the country so heavily relies upon. At the time of the crisis, seventeen Western banks owned subsidiaries in Ukraine, accounting for 40 percent of the country's banking assets. Sensing the urgency for outside assistance, the

IMF stepped in and granted a recapitalization package of $16.4 billion to recapitalize its banking sector and inject liquidity into its budget. This, coupled with the fact that the Ukrainian banking sector was not highly leveraged and large bank owners had deep pockets, allowed Ukraine to struggle its way through the worst of the crisis. The depreciation of the hryvnia helped Ukraine regain its competitiveness and by May 2009 the banking crisis was essentially contained. Åslund deftly relates the CEE crisis to that of East Asia in 1997 saying:

> The East European financial crisis is reminiscent of the East Asian one in 1997-1998: A series of boom years had then led to an excessive inflow of currency, which had boosted both investment and consumption, but also imports as well as current account deficits. Eventually, the private external debt had become a source of concern. This was a classic boom and burst cycle. Like the East Asian countries, Ukraine had no problem with public finances, for the budget was close to balance, and the public debt minimal. The difference, however, was that Ukraine's inflation was far too high. (383)

As previously identified, the high levels of foreign investment (up to 70 percent) in CEE banking sectors have opened the region to increased exposure to international shocks and pressure. A major reason for this enhanced susceptibility is the particular social context of the CEE state in question. Epstein (2008) lists three features of social context that contribute to the state's perception of authority and the likelihood the state will heed policy recommendation from international actors: the discontinuity of sectors and regimes, domestic actors' perceived subordinated status to international institutions, and the normative consistency underpinning the policies in questions (883). High measures of each variable tend to cause CEE states to be more open to external advice and comply with conditionality – the delivery of rewards in exchange for compliance. Regarding sector and regime continuity, for states such as Romania and Slovenia, limited party turnover muffled international financial institutions (IFI) influence during post-socialist reform debates; however, in Poland and Hungary, the rise of political leaders who had not governed before and were uncertain how to preside over major institutional reform made them susceptible and open to IFI advice to upgrade skills, technology, and competitiveness (886). Within this realm, the status theory would suggest that when political leaders face opposition they are more likely to heed IFI advice and engage in higher levels of privatization of state assets in hopes of appeasing domestic interests. Early in the transition phase the desire to retain domestic control became synonymous with communist and anti-capitalist sentiment, and international institutions were believed to possess a higher level of expertise that would help lead CEE states toward the liberal economic order of the West (883). States that felt a subordinated status to international institutions were therefore more susceptible to IFI advice and compliance agreements, all of which pushed for greater privatization of domestic assets. Finally, the normative consistency of the proposed policy changes relates to levels of consensus and practice of those same policies within a region. If CEE states believed the credibility of the advocated policies was not in question and had been proven to yield results, international institutions were more likely to wield significant authority, and compliance with conditionality became more bearable (886).

Social context and conditionality is most evident in the appeal of European Union membership. For many CEE states economic stability and security offered by EU membership were well worth the pains of compliance, as evident from the two most recent EU enlargements in 2004 and 2007. Regarding this study, the possibility of ascension is important to note, as compliance with EU conditionality has led to greater levels of foreign ownership, particularly in banking sectors. For example, it was noted above that Romania at first resisted external advice in the transition period, but changes in Romania's social context toward the end of the 1990s and its eventual ascension into the EU resulted in greater IFI influence, and by 2006 foreign ownership had exceeded 80 percent. Epstein (2006) discusses the role central bank independence (CBI) and agriculture reform has had in post-communist Europe by highlighting the embedded social context of each issue. In many ways, the advent of CBI throughout the region is due to the high levels of sectoral discontinuity and domestic policy failure that enabled international institution advice, technical support, and intellectual power to usher in banking sector reform. Early and consistent efforts by international institutions to build a coalition of support behind CBI was rooted in the belief that EU ascension depended on lower inflation and the preservation of CBI helped defeat opposition for a return of state control (1027, 1029-1030). In contrast, agricultural reform in CEE ascension states failed due to sectoral continuity, a lack of normative consistency, and weak technical consensus behind the proposed reforms (1031). In Poland, where CBI had been achieved, officials keenly pointed out that it was hypocritical of the EU to maintain farming subsidies, while telling CEE farmers to limit subsidies and other forms of assistance in order to remain competitive. This, coupled with the continuous legacies from Poland's communist past, thwarted the impact of argumentation and deliberation from persuading Polish reform in favor of the EU (1033-1034). These nuances of social context and how they have affected economic policy throughout the CEE region help us to better understand the effects the most recent global financial crisis has had on the region.

As another form of market liberalization designed to aid the transition to free-market capitalism and economic prosperity, CEE was encouraged to engage in high levels of international trade. This model of development encouraged post-socialist economies to increase reliance on foreign trade, especially imports of crucial energy supplies. As a result, each respective country began to specialize in productions they had a competitive advantage to trade internationally and ignored the development of a diversified domestic economy. This model of trade and specialization has become accepted as the most efficient form of international commerce, but unavoidably forces countries to more heavily depend on cross-border flows for economic essentials. Russia, in particular, benefited from this new trading arrangement as CEE states became fully dependent on Russian energy supplies, helping Russia store up its coffers with reserves for a rainy day – a big reason why Russia was able to rebound faster from the recent crisis than other countries in the region. However, as the financial crisis dug its teeth in and people reverted to high savings, global demand for goods and services promptly fell to new lows. Banks began tightening their belts and export revenues dried up, rendering private sector borrowers and governments unable to service their external debt.

In the lead-up to the financial crisis, CEE economies had experienced trade deficits due to imports of manufacturing components for assembly and consumer goods outstripping export productions to the Western world (Smith and Swain 2010: 20-21). This overall reliance on export production exposed the region to fluctuations in demand from core trading partners, most notably the EU-15, that then exacerbated the woes of financing current account deficits. Ukraine's vulnerability to the pending global shock was exaggerated in large part to its high dependence on steel and other commodity exports, causing industrial production to decline substantially as global demand plummeted. Because Ukraine was not a member of the EU, experienced a drastic reduction in demand for its key commodity exports, and was essentially cut off from international finance to pay its private debts, it suffered more heavily than other less vulnerable CEE states (Åslund 2009: 383). By comparison, Hungary's fiscal crisis resulted from its inability to finance its large budget deficit, which then spread to the real economy (Smith and Swain 2010: 2).

On the whole, CEE states have experienced a higher level of vulnerability to the recent global financial crisis due to new democratic systems, immature economies, and a high dependence on foreign credit, not to mention its high reliance on international trade (Wagstyl 2009). Recovery and growth prospects continue to hinge on global markets and their own advancements, an unfavorable prospect given the struggles of EU. Many feared that as the crisis hit, cross-border lending would dry up and West European banks would preserve capital for their home markets by selling CEE subsidiaries. Many banks had extremely high exposure in the region, with Austrian banks having CEE loans equivalent to 70 percent of its GDP, followed by Swedish banks with 30 percent exposure (2009). However, in general, total loans to GDP in the CEE region were significantly less than West Europe and thus the impact of the financial crisis less severe. For example, bank lending in Poland (as a percentage of GDP) was 47 percent, while in Britain it was 288 percent (Cienski 2009). To a great extent, "the loss of appetite for eastern risk in western Europe" was of greatest concern, as the threat to the real economy in CEE states was more worrisome if western economies went into recession (Escritt 2009). Given the region's subordinate status in regards to international finance, as late as May 2009 economists remained skeptical the region would experience the return of capital necessary to initiate long-term economic recovery.

As noted above, multinational institutions such as the IMF quickly tried to starve off recession and restore confidence in the CEE with large loans to help stimulate lending. However, recovery in the CEE region has been slow due to "it's past dependence on foreign investment that was now weak, undeveloped local financial markets, and dependence on either commodities (Russia) or a narrow range of manufactured exports (Ukraine)" (Wagstyl 2009). Whereas in theory EU members were more insulated due to the stabilizing role of the EU, the average budget deficit for EU members in the CEE moved from 1.1 percent to 6.1 percent in 2009, and the average government debt ratio climbed to 34.5 percent (Wagstyl 2009). This aside, key multinational institutions were instrumental in promoting swift recovery and preserving the region's long-term growth prospects. In particular, the IMF and EBRD helped convince foreign banks to stand by their subsidiaries in CEE, resulting in the 'Vienna Initiative' and the continued availability of capital to CEE states. Poland was the only European country to not fall into recession after

the crisis, and many are now pointing to its local currency capital market as a decisive factor in this outcome:

> Harnessing domestic sources of financing will boost growth and reduce the vulnerabilities caused by relying on foreign currency inflows. Policymakers acknowledge this [developing a local currency market] will not happen overnight and will require a country-by-country approach. Still, the troubles in the periphery of the eurozone suggest expansion will be slower than before, giving countries time to focus on developing domestic markets. (Bryant and Buckley 2011)

Clearly, without international assistance, firm leadership both in and out of the region, and the swift return of foreign investment, crisis might not have been so narrowly averted.

The outlook for the region remains positive, but hopes of a quick return to pre-crisis growth patterns have been replaced by the realization of a more lethargic and painful healing process. "The legacy of widespread foreign-currency lending, the need to rebuild balance sheets, the sluggishness of the west European market and concerns that continuing eurozone problems could yet cause contagion farther east are all restraining growth." (Buckley 2011) Forecasted growth for the region is ahead of the slow-growing developed nations, but behind the fast-paced emerging markets. Following the crisis Poland, Czech Republic, Slovakia, and Hungary took the early lead in the recovery effort thanks to manufacturing strength, the return of foreign demand, and attractiveness to FDI. In Poland, there has been a revival of banking M&A transactions, a telling sign of the sector's improving health, and any sales of Polish banks are viewed as a result of parent country problems – 72 percent of Polish banks are foreign owned (Cienski 2011). Higher oil prices in Russia and a revived steel market, coupled with improved political stability, in Ukraine have aided recovery in these two nations, but labor markets continue to be tight and domestic demand is behind schedule. For Russia, state-controlled banks were the primary beneficiaries of the state's liquidity bail out, squeezing out smaller private banks and helping to consolidate the sector at large. Interest rates have started to come down and banks are starting to get more aggressive, but some fear a moral hazard exists until Russia can find a way to level the playing field and increase competition in the domestic economy (Weaver 2011). The same is said for Ukraine, as small and inefficient banks are expected to go away or be bought up by foreign groups, but long-run prospects are encouraging for the foreign banks that can endure, as Ukraine has a big economy and a large population that is just now beginning to utilize classic banking services (Olearchyk 2010).

The CEE region provides an excellent case study for the role of democratic free-market economics in the twenty-first century. Following the demise of the soviet state, free-market advocates quickly moved to establish a new form of governance and economics that was believed to promote economic growth and prosperity for all. As this study has shown, the expected benefits of free-market capitalism have been slow to materialize in the region, and it can be argued that the standard of living for the majority has actually deteriorated over the past two decades. Given the apparent failure of capitalism from the recent global financial crisis, many wonder if state-led capitalism will garner more support in the years to come. Pioneered by China and Russia, this form of economic leadership has witnessed impressive results and is sure to entice other emerging markets as faith in the free market has been called into question. Whereas

this form of capitalism has new clout in the global economy, it is not widely accepted that the road to recovery for the CEE region is in the return of state intervention and regulation. As capital continues to flow back into the region, it is not recommended that CEE states abandon market-oriented growth, but emphasize "the development of domestic markets, including financial markets, sound regulation, diversification and the fight against corruption" (Wagstyl 2010). CEE states must be sure to learn from the crisis and adopt new policy that will help shield their economies from excessive exposure and vulnerability, while still using free-market capitalism to improve production capacities. Foreign and domestic banks will undoubtedly face greater regulation but the growth prospects of the region are too high to see the permanent withdrawal of capital so many feared.

The collateral damage suffered by CEE nation states following the bursting of the global banking bubble in 2008 highlighted many of the weaknesses market-oriented capitalism can have if not supported by mature domestic institutions and sound regulatory regimes. Smith and Swain order the 2007-2009 global financial crisis in the CEE region into four chronological stages and the resulting economic effects experienced. The first stage was a result of the liquidity shock experienced from the bankruptcy of Lehman Brothers. During this phase, CEE states highly dependent on foreign capital and experiencing large credit-fueled bubbles suddenly saw their lines of credit dry up and promptly went into crisis mode. During the second stage of the crisis, retarded external demand for exports had exacerbating effects for countries highly dependent on just a few key exports. This then led to a painful period of macroeconomic adjustment as countries tried to quell the damaging effects of financial exuberance with inflation targeting and exchange rate manipulation. The decreased inflow of foreign capital and new stringent austerity measures finally resulted in the ongoing phase of fiscal crisis of the state (2010).

This paper has worked to prove how and why some (arguably most) CEE states have experienced a takeover by Western banking groups. However, it should be noted that foreign ownership of banking institutions does not directly correlate with more lending and financial leverage. My research has shown that not all CEE states with heavily privatized banking sectors engaged in high levels of financial borrowing. Rather, I propose that the presence of Western banking subsidiaries encouraged certain domestic actors within CEE states to take on increasing levels of debt. Not all CEE states that had higher levels of exposure to foreign markets in both the banking and manufacturing sectors were affected the same by the 2008 crisis. Each individual CEE state experienced a different degree of vulnerability based on a complex set of domestic policy and practice. Whereas the liquidity crunch caused by the tightening of foreign-owned financial lending standards has exacerbated and prevented many CEE states from gaining access to much needed capital, full-scale withdrawal and subsequent collapse has been avoided and economic improvement will mirror that of international markets. In addition, countries offering higher levels of social cohesion and political stability have been able to adopt and implement difficult corrective measures and policies that will aid in a faster recovery and return to growth. As a region, Central and Eastern Europe must walk a fine line of openness to foreign capital to promote economic development to catch up to the rest of Europe, all-the-while simultaneously striving to enhance domestic banking services and the creation of domestic markets for its manufacturing sector.

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