Eastern European Currencies Need Help Now

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European Union finance ministers reiterated this week what their leaders said at the March 1 EU summit: no bailout fund for Central and Eastern European. Instead, they again emphasized that each country is a special case. This is of course true, but the regional dimension also cannot be overlooked.

These countries face many similarities: a common past, growth models that to varying degrees rely on foreign capital to finance domestic investment, and banking systems that are largely owned by West European banks. They also compete for trade and foreign direct investment; hence what happens, say, with the floating Polish currency matters for Slovakia—a euro-area member—as well.

So everybody is at risk. The experience of currency crises—including the Asian one of the late 1990s—tells us that even countries with healthy fundamentals can be attacked as contagion spreads. If a currency starts sinking, this will end up affecting other neighboring currencies as well. In turn this will affect the ability of households and companies to repay their debts denominated in foreign currencies. Finally, this will hurt Western banks due to rising losses on the loan portfolios of their local subsidiaries.

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Markets remain worried that the EU has no real response to the crisis in the postcommunist member states. The credit default swap (CDS)—a measure of the cost of insurance against default—of Austrian government bonds rose further after the summit, reflecting Austrian banks' exposure to the region. The EU position that every case in Eastern Europe is different effectively spread the message that some countries are much more vulnerable than others. The Hungarian forint has further weakened while other currencies barely changed, and CDS spreads rose in the more vulnerable CEE countries.

On the plus side, the EU summit affirmed the integrity of the European banking market and stressed that support for Western European banks should not imply any restriction on the activities of their Central and Eastern European subsidiaries. However, this is not enough. Anecdotal evidence suggests that credit contraction in the region is real.

> Markets are worried about the EU's weak response to the crisis so far.

This financial crisis also contains a political risk. Twenty years ago, the ex-communist countries enthusiastically embraced market capitalism and liberal democracy. About a decade ago, however, Russia took a different course after it had experienced a severe financial crisis, and ever since it has remained on its *Sonderweg* of economic nationalism. Clearly, the commitment to democratic values and institutions is incomparably stronger in the CEE countries, but the risks should not be underestimated.

So what can be done? In the medium term, the key challenge is to trigger a resumption of private capital flows to the CEE region while adjusting to a new world of lower leverage and higher risk premiums. The days when a country could run current account deficits in the double digits (as a proportion of GDP) are gone. Households in the region will have to stop spending their expected future income and save more.

In the short run, the key is to avoid further excessive exchange-rate depreciations. Market sentiment is strongly negative against CEE countries and capital inflows are dwindling. Decisive actions are needed. First, strong and credible programs for fiscal sustainability, financial system stability and macroeconomic adjustment are needed in the vulnerable CEE countries to convince markets that their economies will adjust and resume growth in the future. Without these, any external help will have short-lived effects.

The second priority is to temporarily substitute missing private capital inflows with public capital inflows. The IMF, EU and World Bank have already granted large loans to Hungary and Latvia, and the European Investment Bank, European Bank for Restructuring and Development, and World Bank have lent to the private sector of the whole region. The EU also somewhat extended the availability of structural and cohesion funds. However, these actions had only temporary effects.

As a megafund for the region is not a political reality, the way forward is to convince markets that the case-by-case approach is not a fig leaf for inaction. To this end, the EU's medium-term balance of payments facility for noneuro-area member states—established in 2002 with a ceiling of €12 billion that was raised to €25 billion in November 2008—or other European resources should be increased. What's more, disclosing the conditions for disbursing the funds would increase transparency, provide clarity to the markets and decrease moral hazard. The expected increase in IMF lending will also help the region.

Third, the shift in attitudes toward euro membership, especially in Poland, signals that sharp currency depreciation is not desirable. It should be matched on the euro-area side by a willingness to make the entry criteria not softer, but economically sensible. The Maastricht Treaty requires that candidate countries' inflation should not exceed that of the three best-performing EU member states by more than 1.5 percentage points. But it does not specify how to interpret "best performance." At the moment, it is interpreted to mean the three EU countries with the lowest (but not negative) inflation levels. This practice is widely interpreted as a way to defer euro-area enlargement.

Markets would consider it a positive signal if the EU were to abandon this narrow, misguided interpretation. It would make more economic sense to consider either the three countries closest to the euro-area average, or the European Central Bank's definition of price stability—inflation rates of below but close to 2%—which candidate countries could exceed by 1.5 percentage points.

Fourth, the ECB should go farther in recognizing the extent of its regional responsibilities. It could do this by extending currency-swap agreements—a temporary exchange of domestic currencies into euros—to other central banks, or by accepting government bonds denominated in local currencies of noneuro-area EU countries as collateral. Even more radically, it could offer access to its euro-refinancing facilities to banks from noneuro EU countries. Such actions should apply on a temporary basis only, in response to extraordinary circumstances. They would help directly and also have a positive effect on market sentiment.

Fifth, private debt-to-wealth ratios and the ability to pay may become unmanageable in countries that experienced extraordinary credit and housing booms and now face a serious bust. Since debt is mostly private in these countries, the issue of private debt restructuring should be put on the agenda.

Last but not least, Europe must avoid displaying the lack of coordination it has openly demonstrated in recent times. To be reminded by World Bank President Robert Zoellick that the EU has regional responsibilities was embarrassing, but painless. The same could not be said of a similar reminder coming from nervous capital markets. Only coordination and solidarity can beat off the self-fulfilling prophecies in Eastern Europe.

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