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G20 and Emerging Europe: Is There Anything Left for the EU to Do?

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Abstract: *This piece argues that three specific policy issues need to be addressed urgently in Central, Eastern and Southeastern Europe in order to avoid a sustained period of recession or depression: (i) orderly exchange rate adjustment (ii) fiscal stress and (iii) financial sector vulnerability. The G-20 Declaration supports significantly the role of the IMF in the current crisis, but there is a need for an additional determined effort by the EU.*

Emerging Europe, the EU and the IMF

The conclusions of the G20 Summit do not address directly the problems that countries in Central, Eastern and Southeastern Europe (CESE) face. These countries can be differentiated by three criteria: (i) by the distance to the EU and the euro (New Member States, NMS; Future Member States, FMS; Neighborhood States, NS);[1] (ii) by their exchange rate regimes (fixed or floating); (iii) by the state of their external balances (deficit or surplus, the latter mainly oil exporting countries).

When it comes to the NMS, those are mostly countries with current account deficits, but they differ with respect to exchange rate regimes. Slovenia and Slovakia are in the euro zone, the Baltic countries and Bulgaria are on fixed exchange rates (indeed, they mostly rely on currency boards), while the rest float their exchange rates. To all of them, the G20 conclusions offer the opportunity to approach the IMF and make use of its reformed and increased lending capabilities. There is nothing else that would be specific to these countries.

The FMS are in a different position due to the fact that they are financially and in terms of trade integrated with the EU, but cannot hope to be supported by the ECB or by the EU budget to the same extent as the NMS. Therefore, they have to rely more heavily on the IMF. Indeed, most of these countries are contemplating a program with the IMF. Serbia

[1] NMS: former socialist countries that joined the EU in 2004 and 2007: 5 Central European countries (the Czech Republic, Hungary, Poland, Slovakia, and Slovenia); 3 Baltic countries (Estonia, Latvia and Lithuania); 2 Balkan countries (Bulgaria and Romania). FMS: candidate countries (Croatia, Macedonia and Turkey) and potential candidate countries (Albania, Bosnia and Herzegovina, Montenegro and Serbia). NS: Eastern European countries covered by EU Neighborhood policy (essentially former Soviet Union member states or members of the Commonwealth of Independent States now).

already has a standby agreement, Bosnia and Herzegovina is preparing to work on one, and Turkey is probably going to ask for a new program, while the others are more reluctant to go down that road, though that may prove necessary. In these group of countries, there are those who use euro (Montenegro and Kosovo; unilaterally, not as members of the EMU), and those who rely, *de facto* or *de jure*, on fixed exchange rates (Albania, Bosnia and Herzegovina, Croatia and Macedonia), while a minority, Turkey and Serbia, rely on floats or rather managed floats (though Serbia in essence alternates between fixed and floating exchange rate policies). All of these countries report trade and current account deficits, some very large ones.

The NS are an even more differentiated group. Those that have experienced dramatic changes in their external positions, in trade and in exchange rates, have already approached the IMF: Ukraine, Belarus, Armenia, and Georgia. Its increased budget and reformed model of lending may prompt renegotiations of the already existing programs and may also induce other countries to approach the IMF in order to anchor their macroeconomic stability. The exceptions are oil exporting countries that have accumulated large reserves and may not feel the need to seek further financial support (e.g. Russia and Azerbaijan).

Three problems that need addressing

Apart from the strengthened mandate that the IMF has received by the G20 Summit and apart from the effort that this institution has made to reform its procedures and conditions for lending in order to make it easier for countries to approach it, the Summit has not really addressed the main problems that these groups of countries face. These are essentially the following three: (i) exchange rate adjustment, (ii) fiscal stress, and (iii) financial vulnerabilities.

Given that most of these countries run high trade or current account deficits or both, exchange rate adjustments seem mandated. In the case of countries with flexible exchange rates that is being done via nominal depreciation. This, however, threatens the sustainability of their balance sheets – fiscal, financial, corporate and those of the households. Large initial devaluations in some of these countries (e.g. in central Europe) prompted the fear that their banks may run into troubles that may put much of the EU banking sector at risk. The action of the IMF, the ECB, the European Commission and individual European countries with large financial exposure to these financial markets have managed to stabilize the vulnerable exchange rates, but their sustainability will depend on the depth and the duration of the recession in the EU and in these countries. The persistent weakness of the Hungarian economy, for instance, suggests that the existing challenges have not been addressed adequately. Indeed, Romania has recently joined Hungary as an EU member state with rather shaky macroeconomic stability and in need of a similar support package.

Countries with fixed exchange rates are trying to adjust their real exchange rates by wage and expenditure cuts and are facing deep recessions. The Baltic economies are currently shrinking at a rate of about 10% and Bulgaria seems to be entering a rather deep recession too. Things may change if external demand improves dramatically in the next few quarters, otherwise the prospect of a depression may prove unavoidable and their currency arrangements may collapse leading to a disorderly adjustment. The additional problem that countries that are trying to adjust through deflation face is that not very much can be done to help them if they do not want to deviate from that path of adjustment, at least not through the instruments enumerated in the G20 Communiqué. Clearly, fiscal stimulus is not supportive of deflation and the same goes for increased financial support. The IMF programs, where they exist or may be contemplated, could only bring additional support to the exchange rate, but they cannot make this process easier. The alternative, of course, is orderly nominal exchange rate depreciation.

The FMS are, for the most part, in a similar situation as the NMS with fixed exchange rates. The difference is that they have less of an incentive to contemplate a change in their exchange rate regimes, if they happen to rely on fixed exchange rates. This is because they have fewer sources of support for an expansionary fiscal and monetary policy either from the IFIs or from the EU. The new IMF approach to lending could support a nominal exchange rate adjustment, as in the case of the classical Bretton Woods system, but whether that can come together with more expansionary fiscal and monetary policies is an open question. Certainly, the answer will be easier to come with if there were an additional financial support that would target the fiscal and the financial balances. Similar problems are faced by FMS with floating exchange rates and by most NS. Even in the cases where expansionary policies would be advisable, it is not clear how those were going to be financed. These problems have not been addressed by the G20 Summit in their policy conclusions.

Thus, if real exchange rates are to be adjusted and deep recessions and even depressions, with their uncertain political and social outcomes, are to be avoided, sources to support fiscal and financial balances will have to be found. For most countries considered here, EU should be ready to provide that support or at least advocate that it should be provided. This is for the reason that these are either member states or future member states or are economies that are increasingly integrated with the EU single market. So, their macroeconomic stability and growth are important for the EU itself.

Exchange rate adjustment

In addition to the increased and reformed role of the IMF, three policies could be developed by the EU in order to support the stability and growth in CESE. One is orderly adjustment of the exchange rates of countries with unsustainable external balances. The

experience so far seems to indicate that countries with flexible exchange rates have managed to adjust their real exchange rates through nominal depreciation, while countries with fixed exchange rates have yet to manage to do that. Therefore, the latter should be supported in that process. That would mean nominal adjustment similar to that which took place in central European countries with floating exchange rates, e.g. about 20 to 30%. This adjustment may be resisted because of the widespread euroization in these countries. In order to overcome this resistance, various schemes of compensation of various sectors could be used through a combination of tax reliefs or with appropriate transfers.

Fiscal stimulus

In addition and in conjunction with that, there is a need to support these countries in their ability to have a countercyclical fiscal policy. Currently, in the majority of these countries, fiscal deficits are increasing even though public expenditures are declining. This is because of negative growth. Thus, fiscal policy is both pro-cyclical and unsustainable; the latter because it is difficult to finance these higher fiscal deficits. In the case of NMS, some support for fiscal stabilization if not expansion is available, though some countries still have difficulties placing their government bonds (e.g. Hungary). However, most other countries, with the exception of Turkey, can hardly find sources to finance increased public spending. Those sources cannot be found in the IMF loans, so additional sources of sovereign lending should be created. At the moment, the EU has set up a stabilization fund that could perhaps mobilize 600 to 700 million euro for FMS, but that is far too little for what needs to be done to support stability and growth in these countries. A Fund with three to four times that money may prove to be helpful and should not be a huge burden on the EU member states.

Financial stabilization

Finally, more will have to be done to support financial stability of these countries. In a number of cases, e.g. Romania and Serbia, IMF programs have come with the commitment on the part of the EU banks to refinance the corporate sectors in these countries. It is not all that clear what that means in practice as credit and other financial flows to many of these countries are declining rather dramatically. There is a danger that the process of deleveraging of the banks will be accompanied with large number of bankruptcies and rising unemployment in these countries. In addition, that development will leave these countries with higher credit risks that will stifle their growth prospects in the medium run. These problems, arguably the key to stability of the whole region, have yet to be addressed.

Conclusions

In order to make it possible that CESE countries weather the current crisis and go through the process of adjustment that will make it possible to them to return to the path of convergence growth, the increased role of the IMF should be supplemented with:

(i) Orderly adjustment of real exchange rates in countries with unsustainable current account deficits,

(ii) A support for countercyclical fiscal policy, and

(iii) Support for the continuous credit activity of EU banks in order to avoid the process of deleveraging that leaves mass bankruptcies behind.

For all these, huge amounts of money are not necessary, political will and coordination is.