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The Relevance of Greece's Deteriorating Financial Condition for Central and Eastern European Economic Prospects

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Recently, economists have become increasingly concerned about Greece's deepening economic problems as there are no signs its difficult fiscal situation is improving. One of the implications they foresee is a slow-down in the recovery of Central and Eastern European economies. Although in 2008-2009 the economic and financial crisis brought uncertainty to the region's further growth and resulted in a retreat of foreign capital from Eastern and Central European countries, their current stable fiscal and monetary situations may prevent a repeat of this phenomenon.

Structural Problems of Greek Finances**.** The roots of Greece's current financial problems, which affect the whole economy, go back many years and are associated with the serious failings of Greek financial and economic policies. Among the main causes of the current difficulties is the extreme growth of the public sector and, consequently, a limited ability for the government to reduce spending. As a result, Greek government debt throughout the previous decade surpassed the volume of gross domestic product (in 2001, it was 117.2% of GDP). Among all EU countries only Italy has similar debts. In contrast to Greece, though, Italy in 2001-2008 managed to generate an annual average savings rate of 9.3% (average for the eurozone countries was 8.95%). That compares to Greece, which overused its access to cheap credit during the period 2001-2006 and became indebted at the rate of 6.8% per year on average. At the same time, labour costs in Greece grew faster in comparison to countries of the eurozone and against the average of OECD countries for nearly the entire period.

Debt-Service Spiral**.** Until the self-fulfilling prophecy of a loss of credit viability by raising interest rates pulled the Greek state into a debt spiral, the issue of a permanent break with convergence criteria was not a sufficient incentive to take steps to consolidate debt. Although Greece previously had been credible in the eyes of investors in a way comparable to other countries of the eurozone, after it was revealed that financial statements by the Greek authorities had been falsified for many years, there was a sharp cut in its access to cheap credit. Within months, the spread between Greek and German 10-year bond yields jumped sharply to 13.76% (while the spread for the next highest country at risk of insolvency, Portugal, was less than half that, at 6.19%), and sovereign credit default swaps—a kind of insurance protecting buyers from a borrower's default—again was at a record price (3,127 basis points compared to the Portuguese CDS, valued at 643 basis points). Despite repeated assurances by the government that it had the capacity to act unassisted against the crisis, Greece found it necessary to apply for external aid subject to strict conditions. If upon a failure to meet creditors' conditions—as appears to be the case now—this aid will only postpone the country's insolvency problems.

Financial Aid to Greece**.** In May 2010, after the adoption of the fiscal consolidation plan by the European Commission and the IMF, leaders of the eurozone, together with the Fund, adopted a three-year program of support for Greece with a total value of €110 billion. Bilateral loans worth €80 billion came from EMU countries, plus a loan from the IMF amounting to SDR 26 billion (around €30 billion). The aid was conditioned on, among other things, extensive budget cuts and an acceleration of the pace of privatization. The subsequent reform program has been met with violent protests by Greek society. After months of street riots, the process of implementing reforms has been partially paralyzed. Given the worsening situation in other countries (particularly, in Ireland and Portugal, which also have been forced to accept external assistance), the rejection of a recovery program further undermined the financial markets' confidence in Greece. Consequently, a postponement of the decision to declare bankruptcy, according to many experts, ceased to be economically justified. More than 85% of surveyed economists foresee a Greek default.

Crisis in Central and Eastern Europe. Before the financial and economic downturn started, Central and Eastern European countries (CEEC) were boosted to strong economic growth by high FDI inflows and high commodity prices. However, the economic crisis made most of these countries suffer because of capital leakage and lower commodity prices. Investors feared potential losses in the region and withdrew capital. Moreover, for fear of insolvency, financial multinationals withdrew cash to their parent headquarters to help them survive. This provoked a lack of liquidity in the countries of the region and induced a regional economic downturn.

In times with limited liquidity, bubbles present in real estate markets popped and repayment of foreign, private and public debt became a real burden to societies, local firms and governments. The greatest losses in economic welfare were recorded in the Baltic states. Latvia's GDP, for instance, shrank by 4.2% in 2008 and by 18% in 2009, resulting in a high unemployment rate. The economic shock was so strong that the IMF suggested the Latvian currency be devalued (its currency was pegged to the euro). Moreover, as a result of the downturn, governments collapsed in the beginning of 2009. This happened in Hungary, where Prime Minister Ferenc Gyurcsányi's government was compelled to step down.

What is interesting is that the region was not exposed to the U.S. credit markets where the crisis began. Moreover, the level of indebtedness of countries in the region was lower than in the eurozone. However, it was not a viable argument to persuade financial corporations to keep capital in the region. Credit default swaps hit historic highs: 415 points for Hungarian bonds in June 2010 and 410 points for Romanian bonds. Good rates are normally well under 100.

Differences Within the Region. Lessons from recent years show that in the CEE there are several significantly differing countries with diverse economic conditions that endured the crisis in various ways. For instance, Poland in 2009 noted positive economic growth during the general downturn and was the only country in the entire region to do so. Unlike other states in the region, Poland kept floating its currency (which induced significant depreciation of the zloty at times), whereas Slovakia and Estonia joined the eurozone at the beginning of 2009 and 2011, respectively. Poland has had a relatively healthy banking system, as compared to the region and the EU, with limited debt in foreign currencies and tight regulations on lending capital. As a result, credit was not obtained as easily in the past as in other EU member states.

Conclusions. The question is, would CEEC suffer economically once again because of Greece's economic difficulties? The answer seems rather optimistic, even though there is a significant risk factor, notes the Hungarian Central Bank. First, default would not necessarily immediately constitute insolvency as, for instance, other eurozone members might announce further rescue packages in order to save their own economies. Second, even if in the longer term the packages would not work, multinational companies and credit agencies have already started to see, analyze and understand European countries separately. They note now the differences between the heavily indebted Southern European countries and those more moderately indebted in the CEEC. Moreover, the latter have struggled hard to decrease budget deficits in the meantime, thus limiting their risk exposure. Third, parent companies do not necessarily need to withdraw capital from the region to survive as was the case with capital leakage at the beginning of the financial crisis. The Greece-based financial corporations that might need capital back home are only marginally engaged in the Central and Eastern European region. Fourth, local financial regulatory institutions in the region have made progress in tightening lending rules further. Fifth, as a consequence of the previous points, investors are looking forward to a recovery in the CEEC, and are less apprehensive to allocate capital to the region. However, a possible short-term depreciation of local currencies out of greater concerns for the standing of the euro may temporarily and negatively affect borrowers in foreign currency, though it could help exporters in strengthening their terms of trade.