Will the Rich Man's Crisis Crush the Emerging Economies?

Lecture by EBRD President Thomas Mirow

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Professor Buiter,
Ladies and gentlemen,

Thank you very much for the invitation to speak to you today here at the London School of Economics. This is a great honour for me personally and also for the EBRD. Without doubt, this is one of the most prestigious institutions in a city where there is definitely no shortage of highly respected centres of excellence.

In line with the venerable tradition of your university, you have given me a challenging task today and asked me to discussion the question: "Will the rich man's crisis crush the emerging economies?"

In a word, our answer to this question is "no"!

Given the current global situation and more specifically the situation in eastern Europe (and as president of the EBRD I can only speak for the countries of our region which stretches from the eastern borders of

Germany to the deserts of Mongolia, and from the Baltic Sea to Turkey), this statement may seem bold and it obviously deserves some explanation. Allow me to set out in a few points why we firmly believe that emerging Europe will not be crushed by the present crisis.

1. The state we're in

It may seem like an ironic twist of history, but just when they were to celebrate their 20th anniversary of the end of communism and, for many, their 5th year of EU membership, the countries of eastern European countries have been faced with the worst financial and economic crisis for at least a generation.

Although I agree with what Professor Buiter wrote in his blog recently that "some of the central and east European countries were the victims of wild domestic credit and asset market booms and bubbles even before they were hit by the global credit crunch", it is equally true that the global economic crisis did not start in the east, but in our western economies.

The financial turmoil which began in the US affected heavily exposed economies like Ireland and the UK first, and then rapidly spread to the key economies of continental western Europe.

In contrast, the eastern European economies displayed remarkable resilience for a long time and it was only after the leading economies in the

west plunged into recession that eastern Europe began to feel the full impact of the global crisis.

The crisis struck the east when some of the new EU countries were least prepared to deal with it. Gradually adapting to eventual euro-membership some had already given up currency controls. Furthermore, the crisis exposed existing vulnerabilities and imbalances, the main one being their reliance, and in some cases over-reliance, on foreign financing and foreign currency debt.

What is making today’s crisis so serious, perhaps even unprecedented, is that so many adverse factors all seem to be coming together and happening at almost the same time: Credit dries up, production slumps, currencies tumble and, consequently, the real value of the already high foreign debt explodes just as the real economy goes into decline, demand for credit falls and refinancing needs become more and more urgent. It is a vicious cycle.

It would however be a grave mistake to paint the future in colours too bleak.

What we are now facing in some countries in eastern Europe is a severe recession but not a collapse. The adjustment process will be painful enough and test the strength of all involved – from politicians to bankers to the people. But this is not a crisis with runs on banks, or with sovereign defaults. The economic performance in most countries of eastern Europe remains no weaker, and often stronger, than that in western Europe.

There are strong underlying fundamentals in eastern Europe which remain in place and need to be protected. We have every reason to believe that once the present situation has been stabilised, emerging Europe will bounce back strongly.

The situation today is serious, but it is manageable. Solutions, however, do not present themselves out of nowhere: they need to be worked out and implemented.

2. The ballad of east and west

Luckily, the state we’re in is not the Europe of long time past. The Europe we live in may not be fully united but it has been growing together ever since 1945. Kipling’s lines that “East is East, and West is West, and never the twain shall meet” have mercifully been overcome by political and economic developments in Europe.

For the past 20 years the integration of eastern Europe into the world economy has been a remarkable success story. Not only has it provided these countries with a crucial pillar of stability as they have undergone dramatic social changes, but the integration has also happened in a manner that has led to a greater degree of interdependence between east and west than perhaps ever before.

Today, more than 50 percent of the banks in eastern Europe – and in some cases as many as 80 percent – are owned by western banking groups. For

many years this has meant a high inflow of capital, the establishment of a modern banking sector and the availability of loans to the real economy as well as consumers.

Equally, the investments of western companies have led to the revival of existing industrial bases or in some cases even to the creation of new structures. That way the Slovak Republic, which was born under serious concerns about its survival chances when Czechoslovakia split at the end of 1992, became the biggest car producer per capita in the world in recent years.

Today, some of what used to be our west European industrial base is located in the east and south of the continent. As the west moved towards more value-added products and services, the east produced many of the goods we would then buy at affordable prices. With the inclusion of the east, the Single European Market took a large step forward. In this interdependent world protectionism is exactly the wrong answer to our problems and will only make us all poorer in the long run.

Similar to the west, where everybody acknowledges the differences between, say, France and Portugal, there are also differentiations to be made in the east. Among the new EU member states, Hungary and Latvia have been hit earlier and harder by the crisis, in part for the reason Willem Buiter referred to in his blog. The Czech Republic, with little exposure to private foreign currency debt, and Poland, with a large domestic market, are also feeling the crisis but are certainly in a different position. If we look at the economic forecasts some of the countries in eastern Europe are still expected to do better than their peers in the west.

The biggest concern in the region at the moment is Ukraine, which is confronted with a multitude of problems. An inherently instable political situation only exacerbates a grave economic situation. We are encouraged by the recent declarations of unity, the appointment of a new vice prime minister in charge of crisis management and the imminent return to Kiev of an IMF delegation. In this context we call on the decision-makers in Ukraine to honour their commitments. Such a commitment will be backed by the strong partnership of the international financial institutions, including the EBRD. This is not only about much-needed finance, but also about restoring trust in the country.

3. Together we are strong(er)

One can, of course, see Ukraine also as a test case for international solidarity. The stability of Ukraine is of crucial importance for the future of all Europe. Ukraine clearly has a European perspective as acknowledged by the European Union which has granted the country priority status in the European Neighborhood Policy.

And yet, not being a member of the EU, it is in a different position in tackling the crisis than, say, neighbouring Hungary or Poland. Many scholars hold that the modern name Ukraine is derived from “ukraina” in the sense of “borderland, frontier region”. We must not allow it to become a no-man’s land.

As a signal of European solidarity but also of economic sense we endorse the view taken at last week's EU Summit that in providing support to their own banks, west European countries must not prevent those funds being used to help their subsidiaries in eastern Europe. Maintaining the flow of credit and not retrenching behind national borders is crucial for all of Europe. Shutting the door to our neighbours now will also mean shutting the door to our own future.

For the EBRD the crisis in our region is arguably the biggest challenge we have ever faced. We have reacted by raising our business volume this year to €7 billion, an increase of some 25 percent over last year. We have also designed crisis response packages for the banking and corporate sectors and are almost doubling our trade finance programme to maintain vital trade flows.

From the outset of the crisis we have worked closely with other international financial institutions to coordinate our efforts and to complement each other in order to have maximum impact with our limited resources. At the end of February, the EBRD, the EIB and the World Bank Group launched a joint action plan worth almost €25 billion which aims at supporting the banking sector in eastern Europe so that lending to the real economy can be maintained or resumed.

The enormity and severity of the global crisis simply makes it too big for any single actor – not even the United States - to solve it alone. While west European countries have designed rescue packages worth hundreds of billions of euros or pounds, many east European countries lack similar resources. This does not mean there is nothing they could or should do. On

the contrary, the crisis should be the moment to lay the foundations for future sustainable growth. The right steps now will be crucial to regaining confidence.

Behind the dramatic headlines it is easy to overlook that, amid all the doom and gloom, progress is being made. We are witnessing a growing awareness of the severity of the crisis. And as I mentioned before, while some countries now report dramatic falls in industrial output, the banking sector so far has been more resilient than some worst-case scenarios had predicted.

This is not to say that we can sound the "all clear". On the contrary, it is more important now than ever that the international community is moving closer together to find solutions.

This is why expectations for the upcoming G20 meeting here in London could hardly be higher. We expect the summit to endorse global solutions to the global crisis. The international financial institutions are certainly willing to play their role as effective tools of an international crisis response. As Hungary's Prime Minister Ferenc Gyurcsány, who visited the EBRD last week, said: "This crisis cannot be solved country by country. A global crisis needs a global response".

4. Small(er) is beautiful

The EBRD is the institution which brings together east and west in a unique way: All our 30 countries of operations are shareholders, and at the same time our shareholders also include the major western industrialised nations plus the EU and the EIB.

As such the EBRD cannot but believe in the future of emerging Europe.

And it is precisely the experience built up in eastern Europe over the past 17 years that gives us the confidence that emerging Europe will not be "crushed by the rich man's crisis."

Underneath the present problems, many of the fundamentals remain strong.

Eastern Europe offers a huge market. Today it is home to some of the most efficient and productive factories in Europe. It has made considerable improvements in its institutional set-up and business climate. It offers attractive tax regimes and labour costs. Last but not least, it enjoys a well-educated, young and flexible workforce.

Through EU membership or even through EU aspirations, these countries are now more closely integrated within Europe than ever before in their history.

Therefore we believe that eastern Europe will come out of the present crisis, perhaps bruised and battered, but not beaten. But will western

Europe do much better? This seems unlikely and therefore I think it is at least misleading to portray the current crisis as a crisis of eastern Europe.

We still do not know when the worst of the current turbulence will be over, to say nothing of when the recovery will begin. I shall be interested to hear Professor Buiter’s view on this. But what seems likely is that we cannot anytime soon expect a return to growth rates of 5 to 7 percent in the east every year as we had enjoyed prior to 2008.

Of course we will recover. Man always does. But it is likely to happen more slowly, on a smaller scale, and with less stormy developments. We may have to start entertaining the idea that we are witnessing a re-dimensioning of our whole global economic system where some of the things we had taken for granted will become luxury items (again) and others will simply disappear.

In this light we should see this crisis as an opportunity to invest as soon as we can in foundations for our future such as clean energy, renewables and new technologies. The EBRD has made the support of sustainable energy one of its core activities. We have invested more than €2.5 billion in almost 150 projects in 21 countries since mid-2006 and we are currently preparing the launch of our Sustainable Energy Efficiency Initiative 2.

At the centre of the initiative is a simple idea: The less energy we waste, the more we have at our disposal and the less dependent we are on supplies. The potential for savings is enormous and ranges from more efficient production in power plants to the upgrade of insulation in private households. The EBRD is providing finance to such efforts through loans

to local banks for on-lending to commercial and private costumers. Where we already have such programmes in place – like in Bulgaria or the Slovak Republic – they are hugely successful.

More efficient, greener means of production and consumption will also be important elements of our future economic structure as we adapt to the challenges of climate change. We may have to learn to make more out of less – in finance as well as in manufacturing as well as in the use of our resources and commodities. If the result will be less spectacular, but more sustainable growth, we will all benefit.

Thank you very much for your attention.