Eastern Europe: Next credit crunch victim?

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The emerging economies of Eastern Europe and the former Soviet Union have been enjoying a rapid growth in recent years. But are they set to withstand the spreading global credit crunch and a possible recession in the US?

Most economists forecast growth in the region of 5.5% to 6% in 2008, which is slower than in 2007, but still considered robust.

"This is still a fast-growing region with strong fundamentals," said EBRD chief economist Erik Berglof.

Despite painting quite a solid picture for the whole region, economists say there are considerable risks for certain countries.

Country differences

The International Monetary Fund (IMF) said in its November report on Europe that the risks were especially high "for those countries that have been funding large current account imbalances with foreign bank borrowing".

Current account balance is determined mostly by the difference between exports and imports of goods and services.

In energy-rich Russia, which exports oil and gas, its current account surplus is estimated at 6% of GDP for 2007, while for Latvia, the deficit is almost 25% of GDP.

Neil Shearing, Emerging Europe economist at Capital Economics, said more than $300bn (£180bn) of direct investment had came to emerging European economies since 2000.

"The Baltics and Balkans remain particularly dependent on foreign capital to finance their huge current account deficits," he added.

Mr Berglof recognises "high levels of current account deficits, high exposure to foreign borrowing and political uncertainties in some countries", but he says the countries are aware of the problems and know how to solve them.

But Mr Shearing noticed that "given that the roots of this latest global slowdown lie in tighter credit conditions, it is impossible to ignore the impact of weaker capital inflows on regional prospects".

Devaluation fears

Rising inflation, a global problem, remains another big issue in the region.

"Monetary policy faces the difficult challenge of balancing the risks of higher inflation and slower economic activity, although a possible softening of oil prices could moderate inflation pressures," the International Monetary Fund (IMF) said on Tuesday in its World Economic Outlook.

Huge current account deficits and high inflation risks make some currency exchange rates overvalued.

Mr Shearing said that the currencies of the Baltics and Balkans "remain vulnerable to a sharp dip in global recession".

"If a slump in global growth hits investor confidence hard, a disorderly devaluation cannot be ruled out," he said.

"This would almost certainly trigger a recession [in these countries]," added Mr Shearing.

'Anticipated problems'

Economic problems in the US - a further slowdown or recession - are not expected to have a significant impact on Eastern Europe, as the world's biggest economy is not among the region's leading trade partners.

Mr Shearing said that exports to the eurozone reached 40% of GDP in some Eastern European countries, while for exports to the US, the figure stood at just 2%.

Besides, the EBRD's Mr Berglof noticed that the problems in the US economy had "already been anticipated for quite some time", meaning that governments had opportunities to start taking necessary steps.

Nevertheless, the economist believes that though "the region is holding up well", it "will be affected".

One of the reasons is that the performance of Eastern Europe will be largely determined by the eurozone economy.

Reliance on neighbours

"The countries of Central Europe look particularly exposed to a sharp slowdown in the euro zone: if growth in the single currency area dips to 1.5%, Hungary could slip into recession," said Mr Shearing.

He added that in case of a fall in the eurozone's growth rate, "it seems unlikely that domestic demand would be able to offset any external weakness."

But the economist believes that "while the euro zone economy has ground to a halt in past slowdowns, this time around it is expected to perform relatively well".

The IMF said in its November report on Europe that "the broader financial system has continued to function well [in Western Europe, but] money and credit markets remain tight".

Mr Shearing also believes that the Russian economy's performance will have a further effect on Europe's emerging markets.

"An investment boom should keep GDP growth at around 7% in Russia, the region's largest economy," he said.

Russian analysts say the influence of the credit crunch on Russia would be very limited as they expect the Russian government to use its huge stabilisation fund, which has been boosted by rising oil prices, if the liquidity situation deteriorates.

'Challenges ahead'

The important question is whether Western banks, which have been among the biggest investors in Eastern Europe, decide to reduce their involvement.

Mr Berglof believes it is still too early to say: "We need to watch this very carefully."

IMF economists noted in the World Economic Outlook that "so far, foreign bank financing of credit in Eastern Europe has held up well, but this financing could be curtailed if the global situation deteriorates and there are tighter global funding conditions".

Nevertheless, most economists remain cautiously upbeat about the region's outlook for 2008, saying that most governments have been taking steps to bring potentially dangerous economic developments under control.

"Emerging markets have been resilient so far, but face challenges ahead," the IMF said.

"Most emerging markets have been able to continue to attract portfolio flows, and financial markets have been far less affected during this turmoil than in previous years," it added.