TABLE OF CONTENTS

Page

Chapter One. Introduction 3

Chapter Two. The European Union' and Its Member States' Responses to the 2008 Financial Crisis .. 6

II.I.The Outbreak of the Crisis 7

II.II. Acting Together in Solidarity 11

II.III. The Implementation Phase 21

II.IV. The Issue of Inequality 28

Chapter Three. The Macroeconomic Impacts of the Crisis on Central and Eastern Europe 36

III.I. Accession and Adjustment to the EU Policies 36

III.II. The Impacts of the Crisis on Central and Eastern Europe 47

Chapter Four. The Social Impacts of the Crisis on Central and Eastern European Countries 61

IV. I. Socio-political Costs of the Crisis 61

IV. II. Ethnic Costs of the Crisis in Hungary and the Czech Republic 69

Chapter Five. Conclusion 80

LIST OF TABLES

Page

Table 3.1.1 38

Table 3.1.2 40

Table 3.1.3 46

Table 3.2.1. 49

Table 3.2.2 58

INTRODUCTION

The financial crisis that broke out in September 2008 in the United States of America (US) has upset the world economy by means of chain reactions, hence causing global recession. The turmoil emerged in the finance sector, but swiftly has grasped the real economy, thus throwing the global economy into a recession reminiscent of the 1929 Great Depression. The industrialised countries were the hardest hit at the beginning; but the damages have turned out to be heavier for developing countries. The European Union (EU), the largest market of the world, naturally has not gone unaffected. Stock markets fell; and major banks collapsed in the established member states within two weeks time. The crisis then has diffused into the poorer new member states of the EU, engendering nefarious impacts therein. As such, the EU did not miss the global pattern. There were concerns in the EU that the situation would be the worst since the end of World War II.

This thesis is an attempt to reveal the implications of the crisis in the EU context. In that, the objective is to study what sort of problems the crisis has generated in the member states' polities, and what have been the impacts of domestic implications on the EU's multilevel governance. This thesis proposes that the EU's response to the crisis was multifaceted with some nationalist reactions. The thesis also questions the domestic impact of the crisis on EU governance. The research question derives from the EU's claim to be the largest market and one of the strongest economic actors of the world economy. The strongest foothold of European integration has so far been economic integration, specifically the first pillar. In addition, economic integration is the earliest and the most progressed area of integration. Therefore, the intuition is, and the EU claims, that integration should be the most solid, and solidarity should to the firmest, if it is ever to be, in economic area than elsewhere. This thesis aims to test the validity of this claim at the face of the 2008 financial crisis. Crises, *per se*, are phenomena that pose challenges of an unexpected and devastating nature. Therefore, it should not come as a surprise that they cause damages whenever and wherever they arouse. Accordingly, the assertion that a crisis would create nefarious consequences in a given system is not too startling a finding. However, crises also are of a nature that exposes the already existing

vulnerabilities. Therefore, their study is valuable to pinpoint the strengths and weakness of a given system. This is the reason why this thesis argues that the 2008 crisis provides a valuable occasion to test the solidity of economic integration and solidarity within the Union. The choice of the crisis as a subject of study also is appropriate because of its timing; the crisis has come about shortly after the EU finalised its last two waves of enlargement. It is worth reminding that the 2004 and 2007 enlargements brought in the emerging and developing Central and Eastern European economies, mostly in transition. The EU has been arguing that the enlargements, notwithstanding the additional difficulties that they have brought in the Union's functioning, had been smooth and on their way of settling, and that the collective decision making was going mostly well, in a spirit of unity and solidarity between the old and new members. This thesis aims to elaborate on the veracity of this claim in the aftermath of the 2008 crisis, and thereby, on the broader issue of integration. In so doing, this thesis aims to contribute to the existing literature on EU integration, as well as to the larger literature on International Relations. In that, the success of economic integration in its depth and scope has so far been the unassailable argument of the functionalist approaches to European integration; since, therein the community rule applied in its strongest fashion. Furthermore, economic integration also has been a pondering argument of the sociological approaches; because in no other area has the experience with integration outlasted the experience of building the single market. The EU's experience with economic integration for more than 50 years would incite the intuition that if sort of a common spirit is ever to emerge, it must emerge under the first pillar. Thus, in a way, by testing the solidity of EU solidarity and market integration, this thesis envisages contributing to the debates on EU integration. The impact of the crisis is important as a result to assess the relative strength of economic integration in the EU. In addition, measuring EU solidarity and the strength of market integration versus state interests also contributes to the debate on the predominance of state and its interests in the literature on International Relations.

The thesis is structured in three sections. The first section focuses on the EU level; and examines the various actions to counter the turmoil by state actors and the Commission in the period from the advent of the crisis to the European Council (EC)

meeting of March 20, 2009. The objective is to identify whether and if so, the extent to which the actors developed a common EU strategy in fighting the crisis. The second and the third parts concentrate on the context of Central and Eastern Europe, in an attempt to see whether the turmoil has engendered heavier implications in the new member states, and if so of what sort. The second section focuses on the macroeconomic impacts of the crisis, while the last part elaborates on the social impacts of the crisis. The analysis covers the period from September 2008, the month in which the crisis broke out, to March/April 2009 meaning the days around of the EC meeting of March 20, 2009. The research materials to this thesis are official documents and reports by the EU, and by other international institutions such as the IMF, the World Bank etc., as well as the media reports, articles and dossiers. It is hypothesised that the EU's solidarity is vulnerable to the individual interests of the member states, and more precisely those of the older members, and particularly of Germany, Italy, France and Britain.

Chapter II:

THE EUROPEAN UNION' AND ITS MEMBER STATES' RESPONSES TO THE 2008 FINANCIAL CRISIS

This chapter examines the impacts of the financial crisis of 2008 over EU economies and the ways in which the member states and the Commission have attempted to counter the damages. The analysis covers the period from September 2008, marking the outbreak of the crisis, to the end of March 2009 when the European Council (EC) of March 19-20, 2009 took place. The objective is to identify the interests pursued by the Commission and member states, what sort of a strategy, these actors have defined, and the extent to which this strategy has proved successful. The choice of these actors draws on the following reason. The Commission incarnates the integrationist force in the Union; it defends the Community interests and detains the right to initiate a legal action. On the other hand, the Council and the EC are the instances that channel state interests. While the EC defines the main orientations and constitutes the ultimate venue for interstate debates, the Council is a legislative body that corrects, when needed, the Commission's directives. So, by choosing these actors, this thesis aims to understand the interaction between the integrationist drives and state interests, thereby to comprehend whether the integration force can counterbalance state actors. The chapter is structured in two sections. The first part analyses the EU level actions and measures to counter the crisis. In that, the study begins with the immediate impacts of the crisis over European economies, proceeds with the phase of development of EU level actions, and ends by an examination of the implementation period. The second part evaluates the relevance of the Union's crisis management strategy for the EU's functioning. The chapter follows a chronological approach so to trace the process down, thereby to pinpoint coalition patterns between EU actors. The research materials encompass official documents, media reports and articles.

II. I. The Outbreak of the Crisis

This section analyses the period following the outbreak of the crisis. It aims to identify how the crisis has gained Europe and what sort of damages it has made. In so doing, the objective is to track down the immediate reactions by EU actors. In order to fully comprehend the impacts of the crisis, it is necessary to provide some background information.

Although it is possible to trace back the crisis till the beginning of 2008, this thesis takes as the starting point of the crisis September 12, 2008 when Lehman Brothers, the fourth largest investment bank in the US, averred that they were facing a collapse. On September 15, Lehman Brothers filed for bankruptcy, while Merrill Lynch, another leading investment bank, and AIG, an insurance company, declared that they sought rescue. Following these declarations, US stock markets crashed; the crisis gained other institutions and sectors in the country.

The crisis spread over other regions of the world through economic interlinks. On September 16, Asian markets plummeted; Russia closed its stock markets. On September 18, Indian markets experienced intense fluctuations. In Europe, Britain's biggest mortgage lender, the HBOS collapsed. As panic gained citizens, shares plummeted on the London Stock Market; and some leading companies, such as Lloyds TSB and HBOS, launched merger talks. The divulgement of HBOS takeover enkindled the fear of job cuts in Britain. British banks pressured on Bank of England for an extension of the liquidity scheme.[1] In response to these developments, the ECB, the Bank of Japan, the Swiss National Bank, the Bank of Canada and the Bank of England collectively decided to provide extra funding in short-term US dollar markets. The FED lent money to the central banks in Europe, Asia and North America in an attempt to prevent liquidity shortage.[2] In coordination with the FED; the ECB "increased the amount of US dollar liquidity provided to the counterparties

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[1] Liquidity scheme allows banks to deposit assets for which there is little market, such as mortgage-backed securities, in return for Treasury bills, which are gold-plated and used as a source of funding. Seager, Ashley, "King forced into U-turn with extension of liquidity scheme", *The Guardian*, the official website, 17.09.2008, http://www.guardian.co.uk/business/2008/sep/18/bankofenglandgovernor.banking, 19.01.2008.

[2] Elliott, Larry, "Banking crisis: Central banks pump billions in to ease the strain", *The Guardian*, the official website, 18.09.2008, http://www.guardian.co.uk/business/2008/sep/18/marketturmoil1, 19.01.2008.

of the Eurosystem for the 28-days maturity operations."[3] These initiatives yet, failed to attenuate panic on markets. The stock exchanges kept falling both in Britain, and the US. In response to that phenomenon, Britain's Financial Services Authority announced a ban on the short-selling of bank shares; and the FED mentioned a plan to create a federal entity to clear the mortgage-related debts.[4] Next, the US administration declared that it prepared a bailout plan of $700 billion. In short, state actors attempted to restore confidence in the markets by monetary supply. The central banks of various regions, including the ECB cooperated for liquidity provision. However, such confidence building measures could only partly assuage markets in Asia, the US and Britain because panic had grasped people.

Of the various moves by the world's financial actors, the one on which all financial institutions focused was the US bailout plan. The US administration tried hard to convince the Congress in favour of the plan; but the elite opinion was turning against the proposal. Both presidential candidates, Barack Obama and John McCain decried the plan on the grounds that it would offer a "blank cheque for the US treasury to buy up debt".[5] Following the failure of the voting, major firms in Britain augmented job cuts; Ireland fell into recession; and the Commission reported that Germany and Spain risked going through recession as well.[6] To put it in another way, the developments in the US have unsettled Europe regardless of what EU actors did.

The French president and the current EU term president Nicolas Sarkozy called for a world leaders summit to discuss the crisis. Upon this initiative, a G7 meeting was convened on September 22. The leaders concluded on the following points:[7] 1. Commitment to the integrity of the international financial system and to facilitate functioning of markets; 2. Support to the US program on removing illiquid assets that

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[3] European Central Bank, "Measures designed to address elevated pressures in the short-term US dollar funding markets", Press Release, 18.09.2008, the official website, http://www.ecb.int/press/pr/date/2008/html/pr080918.en.html, 20.01.2009.

[4] Clark, Andrew, "Wall Street: US government taking steps to clean up mortgage-related debt", *The Guardian*, the official website, 18.09.2008, http://www.guardian.co.uk/business/2008/sep/18/wallstreet.subprimecrisis, 19.01.2008.

[5] Burkeman, Oliver, "US election briefing: Unity breaks out against Bush bailout", *The Guardian*, the official website, 18.09.2008, http://www.guardian.co.uk/world/2008/sep/23/uselections2008.barackobama1, 19.01.2008.

[6] Kollewe, Julia, "Ireland falls into recession", *The Guardian*, the official website, 25.09.2008, http://www.guardian.co.uk/business/2008/sep/25/recession.ireland, 19.01.2008.

[7] European Central Bank, "Statement by G-7 finance ministers and central bank governors on global financial market turmoil", Press Release, 22.09.2008, the official website, http://www.ecb.int/press/pr/date/2008/html/pr080922.en.html, 20.01.2009.

destabilise financial institutions; 3. Call on other G7 countries to take similar measures; 4. Commitment to full and rapid implementation of the Financial Stability Forum (FSF) recommendations to enhance the resilience of the global financial system for the longer term; 5. Enhancing international cooperation between finance ministries, central banks and regulators.

The state of affairs in Europe was not brilliant. Britain was going through particularly hard times; the Prime Minister (PM) Gordon Brown contacted world leaders to develop a coordinated action plan. On September 26, Brown addressed the UN General Assembly, and advocated for new systems of international regulation of the major global financial players, as well as called on the leaders to be cooperative, responsible and consistent with the rules.[8] The events, on the following days, corroborated the significance of Brown's messages. Apple plummeted in US markets, and Bradford & Bingley shares fell in Britain. These drops engendered the fear of job loss amongst people. Britain nationalised Bradford & Bingley, while Spain's Santander bought Bradford & Bingley's 200 branches.

On September 30, then US President George W. Bush submitted the bailout plan to the US House of Representatives. Despite lobbying, US House declined the bill. This rejection triggered a crash on global stock markets, and bank collapses in various regions of the world. As regards Europe, the failure of the voting aborted the ECB's initiative to conduct a special term refinancing operation to improve the liquidity position of the Eurozone banking system.[9] Also, major European banks successively began falling: The Belgian-Dutch financial group Fortis declared that they were looking for a rescue partner. Belgian, Luxemburger and Dutch governments agreed on a rescue plan for Fortis. Dexia, the Belgian-French municipal lender, collapsed. Royal Bank of Scotland shares lost half their values. The Irish government decided to guarantee the retail deposits for the next two years. In Iceland, the government took control of the major banks in the country. Germany launched a rescue plan for banks in vulnerable situation. President Sarkozy summoned the

[8] Brown's plan envisaged a financial stability forum to be built on five principles of transparency, including sound banking practice, responsibility, integrity and global regulation. Wintour, Patrick, "Gordon Brown calls for end to 'age of irresponsibility' in UN speech", *The Guardian*, the official website, 26.09.2008, http://www.guardian.co.uk/politics/2008/sep/26/gordonbrown.economics, 19.01.2008.
[9] European Central Bank, "Conduct of a special term refinancing operation", Press Release, the official website, 29.09.2008, http://www.ecb.int/press/pr/date/2008/html/pr080929.en.html, 20.01.2009.

leaders of the major banks in France. Central banks increased monetary supply to distress the system. But, the successive bank collapses had instigated the fear amongst people about which bank would be the next to fall. Therefore, the interbank lending rate peaked despite efforts to control panic. On the real economy side, firms, such as Miss Sixty, fell down; UK car firms reduced the working hours. Car companies in France cut jobs. Fears about unemployment escalated; which led employees to go on strike across Europe.

The crisis that emerged in the banking sector in the US diffused into European economies due to the interconnectedness of the financial and banking systems.[10] On the other hand, a number of other factors contributed to the crisis.[11] Of the macroeconomic causes, ample liquidity, low interest rates, and the loose monetary policy in the US, accumulation of large global imbalances, and mispricing of risk and large increases in leverage account for destabilisation. Secondly, firms, supervisors, and regulators showed poor performance in risk management. The lack of transparency in turn, has led to the emergence of a shadow banking system, and has introduced an extreme complexity into system, which only a restricted number of people could understand. Thirdly, credit rating agencies failed in the ratings of structured products, and major conflicts of interests impeded the system. Fourthly, corporate governance was problematic; weak shareholders often mismanaged firms; and remuneration schemes have given wrong incentives. Fifthly, regulation and supervision mechanisms have underperformed; they have underestimated or misjudged macroprudential risk; derivatives markets were not regulated. Finally, global financial institutions such as the IMF, the FSF or G20 have remained weak due to the lack of coordination.

In sum, in a short period of time, the financial crisis originated in the US gained momentum in Europe, through the interconnectedness of the banking system. The Eurozone countries received the immediate impacts, because their banking systems were more developed and more integrated in the international financial system. In this period, major European banks collapsed one after another; most Eurozone

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[10] Schor, Elana, "Wall Street crisis spreads through Europe's banks", *The Guardian*, the official website, 30.09.2008, http://www.guardian.co.uk/business/2008/sep/30/banking.europeanbanks, 19.01.2008.

[11] European Commission, *Brief Summary of the Larosiere Report*, 25.02.2009, the official website, http://ec.europa.eu/economy_finance/publications/publication14529_en.pdf.

governments nationalised ailing institutions; stock exchanges plummeted; and firms began closing off. As panic dominated European societies, social discontent escalated, despite government efforts to circumvent it. State actors initially turned to unilateral solutions such as liquidity provision. But, they also sought cooperation and coordination at the global level, knowing that individual strategies were unlikely to prove successful in economic interdependency. "Europe's high level of economic and financial integration called for strong coordination of public policies."[12] Furthermore, independent financial authorities tried to coordinate their actions. The ECB cooperated with the FED and other central banks in an effort to control liquidity shortage. One striking point in the process was that all global financial actors, including the European ones, proved to be dependent on decisions taken in the US. In other words, the US continues to be the most influential actor in the international system. That the failure of the US bailout plan aborted ECB measures, caused stock market crashes and successive bank collapses in Europe show that the EU was not yet as powerful an actor as it aspires to become. So, this part examined the immediate impacts of the crisis over Europe. The next section dwells upon the Commission and the state actors' efforts to develop a common action, and to maintain its solidarity.

II. II. ACTING TOGETHER AND IN SOLIDARITY

This section elaborates the period in which EU actors set about to develop a common action plan. The analysis covers the period from October to December 2008. The objective is to pinpoint the priorities of EU actors in dealing with the crisis, hence the sort of measures they decided to take.

In the EU, the attempts to take collective action began in October 2008. On October 1, the Commission proposed a revision of rules on bank capital requirements, the restriction of the ceiling of bank lending, the establishment of national supervisory authorities to overview the activities of cross-border banking groups in an effort to restore confidence in the financial markets.[13] On October 2, the Commission

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[12] Zoli, Edda, "Europe Battles a Deep Recession", *IMF Survey Magazine*, Countries & Regions, the IMF official website, 12.05.2009, http://www.imf.org/external/pubs/ft/survey/so/2009/CAR051209A.htm

[13] European Commission, "Commission puts forward a revision of rules on bank capital requirements", the official website, 1.10.2008, http://ec.europa.eu/economy_finance/thematic_articles/article13203_en.htm, 21.01.2009.

tightened the rules to safeguard European banks from meltdown. On the other hand, the major problem in the markets pertained to liquidity shortage. Therefore, Commission President Barroso discussed with EU President Sarkozy the "EU bailout plan". Following this initiative, President Sarkozy invited Britain, Germany and Italy for emergency talks in Paris on October 4, 2008. Besides conveying solidarity messages and calling for common action, the four leaders agreed on providing €300 billion of aid to ailing small businesses across the EU.[14] The four also called for a global economic summit that would convene the G8 leaders, plus China, India, South Africa, Brazil and Mexico.[15] The decisions taken at the emergency talks then entered the agenda of the Ecofin council of October 6-7. The ministers established that "member states were facing common shocks" (despite disparate effects on the economies and across groups); therefore, the Community needed to develop a common action plan.[16] The ministers agreed to support growth and monetary policy, reduce inflation thereby protect the purchasing power, restore confidence on financial markets through full implementation of the October 2007 roadmap, avoid excessive tightening of credit toward SMEs, and be proactive in the international arena.[17] So, the EU's strategy towards the financial system consisted of increasing transparency in the banking sector, enhancing retail deposit guarantee protection and providing liquidity. As regards the real economy, the EU aimed to lessen social costs through demand stimulation and growth policies. These initiatives established the basis to the succeeding actions. It is noteworthy that the guidelines defined by the four members, France, Britain, Germany and Italy, influenced the outcome of the Ecofin meeting.

To ensure the appropriate liquidity conditions for financial institutions, European central banks immediately cut interest rates on October 8. Also, the Commission established a high-level group, Larosière group, to set the principles of an effective supervision for global financial institutions. The EU level measures however, did not suffice to rectify economy. Therefore, the heads of state of the Eurozone countries again convened at an emergency meeting on October 12. Reaffirming the need for enhancing cooperation procedures amongst member states,

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[14] Helm, Toby, "Europe calls for global summit on bank crisis", *The Guardian*, the official website, 04.10.2008, http://www.guardian.co.uk/politics/2008/oct/04/paris.economy, 20.01.09.
[15] *ibid*.
[16] European Commission, Bulletin "EU-10-2008 (en) 1.7.6.", the official website, http://europa.eu/bulletin/en/200810/p107006.htm, 20.01.2009.
[17] *ibid*.

the leaders agreed to provide liquidity to ailing financial institutions, state aids so to speak. This strategy encompassed provision of additional capital resources, recapitalisation of distressed banks, and simplification of the funding of banks.[18] To ensure flexibility in the implementation of accounting rules, the leaders invited the Commission to apply flexibility in state aid decisions.

Following the demand by member states, the Commission issued the communication on temporary Community framework for State aid measures on October 14. The Commission pursued two objectives in regulating the state aids; to unblock bank lending to companies thereby guarantee continuity in their access to finance; and to encourage companies to continue investing. Maintaining investment was crucial for the sustainable growth objective of the Lisbon Strategy and for environmental policies. Halt in investments would be disastrous especially for environmental projects, because the Commission had been pushing companies through for restructuring of production and plantations, and the EU had been trying to arise as a leading actor on the international stage.[19] The existing regulation on state aids mainly targeted the SMEs, and aimed to assist them in areas such as access to finance to R&D, innovation, training, employment, environmental measures. Aids were conditioned upon compatibility with the energy and climate change policies. Building on this framework, the Commission allowed state aids under the forms of guarantees, subsidised interest rate, and production of green products. The aid "should not exceed a cash grant of €500 000 per undertaking; it should be granted in the form of a scheme to firms which were not in difficulty on 1 July 2008; it may be granted to firms that were not in difficulty at that date but entered in difficulty thereafter as a result of the global financial and economic crisis. The aid schemes would not apply to firms active in the fisheries sector; and the aid would not be used as export aid or aid favouring domestic over imported products".[20] In addition, the Commission simplified the short-term export credit measures, and the procedure for

[18] "Summit of The Euro Area Countries, Declaration on a Concerted European Action Plan of the Euro Area Countries", Economy and Finance Publications, the official website, 12.10.2008, http://ec.europa.eu/economy_finance/publications/publication13260_en.pdf, 21.01.2009.
[19] European Commission, "State Aid Control", the official website, 13.10.2008, http://ec.europa.eu/competition/state_aid/legislation/horizontal.html, 21.01.2009.
20 European Commission, "Communication from the Commission — Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis", Official Journal of the European Union, 22.1.2009, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:016:0001:0009:EN:PDF, pp.3-8.

rescue packages. Also, the communication defined the measures that would not be considered state aid. Measures such as delay in payment deadlines for social security and similar tax extension would be in order provided that they applied to all companies in and outside the territory.[21] State aids posed a challenge to coordination and harmony at the EU level; because the crisis, having engendered impacts at different degrees across member states, would lead to different aid packages whose implications on competition would be hard to control. Accordingly, the Commission had greater responsibility to ensure coherence between national action and European action, and especially coherence between actions by Eurozone members and by those outside it.[22] In other words, this measure increased the Commission's supervisory role; and underlined the need for a stronger Commission.

On October 15, the Commission tackled the problem of depositors' confidence in European banks. In that, depositors were unsure that their money would be adequately protected if their bank failed. Such a guarantee in fact, existed up to at least €20 000 within the framework of the Directive on Deposit Guarantee Schemes. But the ceiling was not high enough to assuage depositors' worries, since it allowed member states to cover only 90% of savings. The fact that a certain portion of savings may not be covered, added to uncertainty. Besides, the payouts would be released within three months time, whereas even a week could be detrimental for firms in the context of crisis. Hence, the Commission proposal increased this ceiling to €100,000; ensured the totality of deposits would be reimbursed up to the coverage level; and reduced the payout delay to three days.[23]

The EC of 15-16 October adopted the Commission's state aid plan and measures on banking sector. It also welcomed measures concerning the accounting standards, and the establishment of an informal warning information-exchange and

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[21] *ibid*.
[22] Barroso, José M.D., President of the Commission, "Creating a European Response to a Global Crisis", European Parliament of Enterprises, Brussels, 14 October 2008, EU press releases, http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/525&format=HTML&aged=0&language=EN&guiLanguage=en, 21.01.2009.
[23] The proposal suggested revision to EU rules on deposit guarantee schemes in accordance with the decision taken at the Ecofin on 7 October 2008. European Commission, "Proposal on Amendment of the Directive on Deposit Guarantee Schemes", the official website, http://ec.europa.eu/internal_market/bank/docs/guarantee/citsum_en.pdf, 21.01.2009.

evaluation mechanism.[24] Thereupon, governments immediately set to design rescue packages. On October 16, Germany, France, Austria and Spain made rescue packages of, approximately, €2 trillion. In the following two weeks, Italy, Sweden, Poland, and Norway also issued rescue packages. These aids were crucial for domestic problems; but they also mattered for EU actors (Britain, France, Italy and Germany in particular) because of the latter's desire to outdo US performance of crisis management thereby to demonstrate their grandeur on the international arena. President Sarkozy statement that "United Europe has pledged more than the US" illustrates the ambition.[25] Likewise, pointing at the fact that the US nationalised its banks on October 14, days after nationalisations in Europe, Italy's Unicredit bank reported, "European policymakers were racing ahead of the US in their efforts to solve the crisis".[26] To make a recapitulation in passing, the EU has kept to its commitment to develop a common action. The term 'common action' however, is misleading. What the EU has managed to build up is a set of measures with a same objective, but whose character depends on domestic needs. Also, the so-far adopted measures targeted the Eurozone rather than the non-Eurozone. The concerns of the Eurozone countries, particularly those of the four old member states, marked EU level strategies, which the decision on state aids to ailing financial institutions and sectors demonstrates. That the Eurozone countries were the one that developed rescue packages affirms this inference. Finally, the disparate character of state aids increased the Commission's role as the supervisor and coordinator.

As regards the second commitment, the ECB announced the release of €5 billion loan facility to Hungary on October 16. The ECB's bailout was unprecedented, because Hungary was not a Eurozone member. In so doing, the ECB aimed to contain the implications of the crisis in the country; because otherwise, other players, such as Austrian banks, which held heavy investments in Hungary, risked being affected.

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[24] Council of the European Union, "EC Presidency Conclusions", 15-16 October 2008, the official website, www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/**ec**/103441.pdf, 20.01.2009.
[25] Traynor, Ian, "EU takes a €2 trillion financial gamble" *The Guardian*, the official website, 14.10.2008, http://www.guardian.co.uk/business/2008/oct/14/europe-europeanbanks, 20.01.09.
[26] *ibid*.

The EU faced far greater challenges than the US in facing the crisis, because of the coordination and monitoring problems. Supervision and regulation at the EU level remained inadequate in the crisis context.[27] Therefore, the Commission, on October 29, released a communication on a European framework of action wherein it proposed further measures to guarantee deposits, and to supervise operations on the financial markets (especially those concerning the derived products and speculative funds and funds of capital reinvestment) while stressing the need to redefine the structure of regulation and supervision.[28] The communication buttressed the necessity to respect competition rules, to augment the investments in R&D, and to promote environmental friendly sectors. With regards to unemployment, it proposed reprogramming the European social funds in an effort to reintegrate workers into job market, controlling the impacts of the crisis on the sectors undergoing structural adjustments through state aids, and reforming taxation and income support schemes. Finally, the Commission asserted the need to pursue international cooperation, particularly with regards to restructuring of the global financial system.

Despite measures, European economies could not circumvent the recession risk. The British government launched construction plans to boost economy. Nevertheless, public finances made an unprecedented deficit; interest rates were cut down; and job supply shrank off, hence resulting in the biggest drop in GDP that the British economy has made since 1990. In the Netherlands, the ING bank demanded injection from national authorities. In Germany and France, job cuts augmented. Besides, the crisis produced a domino effect over Eastern Europe. Various countries, such as Ukraine, Turkey and Hungary sought loans from the IMF.[29] Shares sharply fell in Asian markets. The Bank of Japan cut down on interest rates for the first time in seven years;[30] and the FED further reduced interest rates. Commission forecast for the 2008-2010 period stated that the nefarious impacts of the crisis would deepen in the

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[27] Almunia, Joaquín, Commissioner for Economic and Monetary Policy, SPEECH/08/534, "Boosting growth and productivity in an open Europe", DG ECFIN Annual Research Conference - Centre Borschette, Brussels, 16.10.2008, The EU's official website, http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/534&format=HTML&aged=0&language=EN&guiLanguage=en, 20.01.2009.

[28] European Commission, "Communication on From financial crisis to recovery: a European framework for action", the official website, http://ec.europa.eu/commission_barroso/president/pdf/ press_20081029_fr.pdf, 21.01.2009.

[29] Gow, David, "From the Baltic to Turkey, fears grow of domino effect as nations seek rescue", *The Guardian*, the official website, 28.10.2008, http://www.guardian.co.uk/business/2008/oct/28/creditcrunch-globaleconomy1, 20.01.2009.

[30] McCurry, Justin, "Japanese interest rates cut for first time in seven years", *The Guardian*, the official website, 31.10.2008, http://www.guardian.co.uk/business/2008/oct/31/globaleconomy-japan, 20.01.2009.

real economy. The Commission expected unemployment to rise, and the inflation to fall as a result of the tightening purchasing power of households. Rising inflation and unemployment would increase pressure on public finances.[31] In this gloomy context, France, Germany, the Netherlands, Portugal and Sweden prepared their state aids by the end of October 2008. Belgium, Denmark, Finland, Spain, Greece, Hungary, Italy, Latvia and Luxembourg finalised their support schemes in November.

The Ecofin Council convened on November 4, 2008 to evaluate the economic situation. The ministers agreed to strengthen the fight against VAT fraud, to introduce a computerised excise duty monitoring system, and to increase the ceiling for financial assistance to the balance of payments in the event of financial difficulty of a member state. [32] In this vein, the Council decided to grant a loan of €6.5 billion to Hungary. The loan was a part of the €12.5 billion assistance package from the IMF and €1 billion from the WB. The Council conditioned the assistance on the implementation of accompanying measures, the consolidation of the budget and the reform of budgetary governance. Hence, by providing assistance to Hungary, the EU demonstrated its solidarity.

The Brussels meeting of the heads of states on November 7 confirmed these decisions. Moreover, the leaders defined a common position for the incoming G20 Washington Summit. The EU position covered the following points: international regulation to encompass all financial institutions, market segments and jurisdictions; the convergence of accounting standards; the establishment of codes of conduct to avoid excessive risk-taking in the financial sector, including in the area of systems of remuneration; to give the IMF a greater role in restoring confidence and stability; and to submit rating agencies to registration, surveillance and rules of governance.[33] The heads of states also charged the Council and the Commission to submit to the next EC meeting a European strategy. One reason underlying the willingness for international

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[31] European Commission, "European Economy, Economic Forecast", Autumn 2008, Economic and Financial Affairs, the official website, 03.11.2008, http://ec.europa.eu/economy_finance/publications/publication13290_en.pdf, 22.01.09.

[32] Council of the European Union, "2901st Council meeting", *Press Release*, 15067/08 (Press 311), Brussels, 04 .11. 2008, the official website, http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/103811.pdf, 20.01.2009.

[33] "Informal meeting of the Heads of States and Government of the European Union on 7 November 2008", the official website, http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/misc/103873.pdf, 20.01.2009.

cooperation was the desire to outdo US leadership in the international arena. Another reason was that individual and even EU level strategies would not suffice to save states when the international environment lacked certainty. Collective action at the international level was a must to reform the financial system.

The G20 Summit[34] on Financial Markets and the World Economy took place on November 14–15, 2008.[35] The summit gathered, for the first time, the leaders of all rich and emerging economies, which represent almost 90% of the global GDP.[36] The summit followed from the initiatives by France, Britain and the US, upon the guidelines set at the G7 meeting of October 11, 2008. The establishment of the guest list caused conflict between the US versus Britain and France. France and Britain wanted a Bretton Woods II-style gathering to outdo US prestige on the international stage. President Bush however, insisted on a G20 gathering, so as to dilute European dominance. Bush plan became the winner. The leaders laid down the common principles (transparency, integrity, responsibility, and sound banking practice) for reforming the financial markets, and launched an action plan; and reaffirmed their commitment to free market. It is noteworthy that the summit exhibited the big member states' ambitions on the international arena. However, both the place and the guest list of the summit showed that their preferences could not overweigh US preferences.

Back home, the issue on the agenda also was the preparation of a common action plan. The Commission announced the European Economic Recovery Plan (EERP) to come out on November 26.[37] In the meantime, the Commission issued a proposal on the regulation of credit rating agencies in an effort to increase investor

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[34] "The Group of Twenty (G-20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important industrialized and developing economies to discuss key issues in the global economy. (…)The G-20 was created as a response both to the financial crises of the late 1990s and to a growing recognition that key emerging-market countries were not adequately included in the core of global economic discussion and governance.", "About G20", the official website, United Kingdom 2009, http://www.g20.org/about_what_is_g20.aspx

[35] "2008 G-20 Washington summit", *Wikipedia*, http://en.wikipedia.org/wiki/Bretton_Woods_II, 20.01.2009.

[36] "Not a bad weekend's work", *The Economist*, the official website, 16.11.2008, http://www.economist.com/finance/displaystory.cfm?story_id=12623258, 21.01.2009.

[37] Almunia, Joaquin, European Commissioner for Economic and Monetary Policy, "A recipe for recovery: the European response to the financial crisis", 2nd Brussels' International Economic Forum, Brussels, 11 November 2008, Press Release, the EU official website, http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/601&format=HTML&aged=0&language=EN&guiLanguage=en, 20.01.2009.

protection through enhanced transparency and surveillance; [38] and signed a Memorandum of Understanding and a loan agreement with Hungary. The EERP came out on November 26. The plan built on the framework as defined by the Stability and Growth Pact (SGP). It aimed to restore consumer and business confidence, to stimulate investment and innovation, to pursue structural reforms especially with regards to the environmental standards, and to alleviate human cost of the crisis by reducing job losses, by assisting people in their reintegration into the job market. [39] The EERP took actions along three lines; international cooperation, coordination at the EU level and between national actions and EU actions, and the use of macroeconomic policies to sustain growth. The EERP allowed a temporary fiscal stimulus of around €200 billion (1.5% of EU GDP), within both national budgets (around €170 billion, 1.2% of GDP), and EU and European Investment Bank (EIB) budgets (around €30 billion, 0.3% of GDP) for loans to SMEs to be distributed through commercial banks. The plan defined measures to simplify the procedure for SMEs and to promote cash flow such as the removal of the requirement to prepare annual accounts, or reducing the fees for patent applications. Furthermore, the plan simplified the rules on state aid approvals, and called on the member states to reduce social charges on employers. Finally, the EU set out short term measures to boost demand and investment in infrastructure projects. It is worth reminding that most EERP measures aimed to protect the supply side, and they mainly concerned the Eurozone economies.

On December 2, the Ecofin council approved the EERP, the directives on bank deposit systems, bank capital requirements, and solvency of insurance companies. The council invited the member states to swiftly establish national schemes to support the banking sector. [40] It also called on the Commission to issue the guidelines for recapitalisation of the distressed institutions. The Commission fulfilled this task on

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[38] European Commission, "Commission adopts proposal to regulate credit rating agencies", Press Release, the official website, 12.11.2008, http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1684&format=HTML&aged=0&language=EN&guiLanguage=en, 20.01.2009.

[39] European Commission, "A European Economic Recovery Plan", COM(2008) 800 final, the Eurolex official website, 26.11.2008, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2008:0800:FIN:FR:PDF, 21.01.2009.

[40] Council of the European Union, "2911th Council meeting", *Press Release,* Brussels, 2.12.2008, the official website, http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin /104530.pdf, 20.01.2009.

December 5.[41] In the meantime, the ECB reduced interest rates to 2.5%, which constituted the biggest reduction since the introduction of the euro.[42] Finally, the EC of December 12-13 approved the EERP, the guidelines for recapitalisation, and the reduction of interest rates.[43] Thus, the EU managed to develop a common action plan by the end of the year. In 2009, the EU set about to implement the EERP, as well as to promote its actions with regards to liquidity provision, regulation, supervision, and financial solidarity.

This section identified that EU actors made initiatives to develop a concerted action in this period. The four members, Germany, Italy, France and Britain, kicked the process off, and cued the Council meeting of October 14 and the EC of October 12 by the guidelines that they defined at the emergency meeting on November 4. The EU took action along three lines; the banking sector, the real economy and international cooperation. The Union first dealt with the issue of state aids, since liquidity shortage and the crisis in the banking sector were the immediate threats to European economies, particularly those in the Eurozone. The Commission, in its communication, regulated the conditions to provide state aids to ailing financial institutions and sectors. Accordingly, governments developed rescue packages. One problem arising from this practice was the risk that state aids of different nature disturbed the proper functioning of the single market. This eventuality compelled the Commission to ameliorate the existing legal framework on supervision and regulation. Accordingly, the Commission's supervision and monitoring roles have become more important than before. Secondly, by issuing the EERP, the EU kept to its first promise, that of defining a collective action plan. Most EERP measures however, targeted Eurozone economies rather than non-Eurozone ones. It is worth noting that where EU level actions remained insufficient state actors gathered at emergency meetings to define individual measures in a concerted way. Thirdly, the EU, particularly the four old members, actively partook in the international efforts to reform the global financial system. They attempted to outdo US leadership by

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[41] European Commission, "Communication on Recapitalisation of financial institutions in the current financial crisis", 05.12.2008, the official website, http://ec.europa.eu/competition/state_aid/legislation/recapitalisation_communication.pdf, 21.01.2009.
[42] European Central Bank, "Monetary policy decisions", *Press Release*, the official website, 4 December 2008, http://www.ecb.int/press/pr/date/2008/html/pr081204.en.html, 20.01.2009.
[43] Council of the European Union, "conclusions", Brussels, 11 and *12 December 2008*. 17271/08, the official website of the Presidency, http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/104692.pdf. 21.01.2009.

affecting the guest list and the outcome of the summit. However, the US maintained its domination in the international arena. As regards the solidarity commitment, the EU granted financial assistance to Hungary. The ECB, which only funds the Eurozone members, offered a grant, considering the gravity of the downturn in Hungary, and its eventual spread over the Euro non-Euro areas. Thus, in this period, the EU seems to have kept to its promises. The next part examines the implementation phase of common actions.

II. III. THE IMPLEMENTION PHASE

This section examines the period of implementation of the EU level decisions. The objective is to comprehend how EU actors detailed the common guidelines and what sort of obstacles emerged in the process.

Following the adoption of the EERP, the Commission immediately set about to implement the decisions. It began by addressing unemployment. On December 16, the Commission issued a proposal on new skills for new jobs to counter short-term unemployment. Therein, the Commission aimed to create jobs by matching skills with vacancies, by organising skills assessments on a permanent basis, and by improving information sharing between member states.[44] The Commission also envisaged spurring employment through the transition to low carbon economy. The Commission set to scrutinise on a monthly basis the labour market developments so as to respond effectively to the needs.

As regards regulation, the Commission issued a proposal to support specific activities in the field of financial services, financial reporting and auditing on January 23, 2009.[45] The proposal enabled direct contributions to the funding of the reporting and auditing bodies (such as the European Financial Reporting Advisory Group, International Accounting Standards Committee Foundation or Public Interest Oversight Board) under the Community budget. With regards to financial solidarity,

[44] European Commission, "Communication on New Skills for New Jobs", Brussels, the Commission official website, 16.12.2008, http://ec.europa.eu/social/BlobServlet?docId=1496&langId=en

[45] European Commission, "Commission Proposal of establishing a Community programme to support specific activities in the field of financial services, financial reporting and auditing", the official website of the EC, 23.01.2009, http://ec.europa.eu/internal_market/finances/docs/committees/financing-decision_en.pdf.

the EU concluded with Latvia, a Memorandum of Understanding and a Loan Agreement that provided up to €3.1 billion, on 26 January.[46]

Throughout February 2009, EU actors were busy with implementing the EERP, monitoring public finances, and restructuring the international financial system. At the EU level, the Ecofin Council of February 10 considered, among other things, the implementation of the EERP, financial stability and reduced VAT. The ministers approbated VAT reduction, on a permanent basis.[47] Accordingly, the Czech Republic, Denmark, Germany, the Netherlands, Poland, Spain, Sweden, Finland, France and the United Kingdom adopted fiscal stimuli. Furthermore, the Council allowed financial support to investments in the energy and infrastructure sectors. Seeing the concerns about protectionism and competition, the Commission was invited to review the proposal in this matter.

At the international level, the EU attended a G7 meeting on 13-14 February, 2009. The issue on the floor was the increase of the IMF funding and the problems on the real sector. The G7 agreed to reform the IMF and increase its funding, in an effort to prevent an eventual spill of the financial turmoil over the emerging markets and low-income countries. In addition, the G7 decided to augment liquidity and funding through the FSF, regional development banks and the World Bank (WB).[48] As regards the real economy, the G7 set to temporarily use individual fiscal stimulus to boost domestic demand and job creation. The ministers also welcomed financial assistance for vulnerable sectors and firms. They underlined that they would continue to monitor exchange markets closely and to take necessary measures against protectionism. It is noteworthy that Ecofin decisions overlapped with G7 decisions.

Following the summit, the US adopted the American Recovery and Reinvestment Act of 2009. The bill, which President Obama signed into law on February 17, was a $787 billion stimulus plan that contained measures such as tax

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[46] European Commission, “EU provides €3.1 billion Community financial assistance to Latvia”, the official website, 03.02.2008, http://ec.europa.eu/economy_finance/thematic_articles/article13872_en.htm
[47] Council of the European Union, “Council Decisions”, Brussels, *Press Release*, 10 February 2009, 6069/09 (Presse 32), http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/106007.pdf
[48] Communique of G7 Finance Ministers and Central Bank Governors, “Statement of G7 Finance Ministers and Central Bank Governors”, Rome, Italy, February 14, 2009, 2009 Italian Presidency Meeting, http://www.g7finance.tesoro.it/opencms/opencms/handle404?exporturi=/export/sites/G8/it/2009ItalianPresidency/Meetings/February/Communiques/Documents/Comunicato.pdf&, p.1.

cuts, expansion of unemployment benefits and other welfare provisions, and spending in education, health care and infrastructure.[49] Some member states had already adopted fiscal stimuli in 2008 to cope with the crisis; namely Bulgaria, the Czech Republic, Denmark, Germany, the Netherlands, Poland, Sweden, Finland and Britain. The Commission monitored individual actions, and assessed the stability and convergence programmes of member states. It identified that the budgets of the countries that took fiscal measures remained within the limits of the SGP; whereas Ireland, Greece, Spain, France, Latvia and Malta made a budget deficit of more than 3% in 2008.[50] In 2009, member states again, considered providing assistance to some ailing sectors as well. The car industry provides an example.

In line with the EU decision of bailing out ailing institutions and sector, car producing member states prepared state aids in the automotive industry. Germany offered tax incentives for the new cars market; France improved liquidity access.[51] Thereupon, the Commission issued a communication to regulate financial support to the car industry; also tightened supervision in this area.[52] Nevertheless, the French bailout plan to car industry, issued in February 2009, attempted to break the competition policy in the Union. In that, France conditioned state aids on not to close production sites in France during the duration of the loan.[53] The plan raised objection by member states, whereupon the French government annulled the territoriality clause.

Aid schemes have turned out to be problematic for competition. Because the crisis had generated impacts at different levels across member states, the EU could not take a uniform measure; it had to leave the design of support schemes to governments. However, governments, as the case of French bailout demonstrates, got

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[49] "The American Recovery and Reinvestment Act of 2009", the official website of the White House, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1enr.pdf

[50] European Commission, "Commission assesses Stability and Convergence Programmes and presents reports under excessive deficit procedure", the official website, 18.02.2009, http://ec.europa.eu/economy_finance/thematic_articles/article13960_en.htm

[51] "Ministers gather for car industry 'summit'", *Euractiv*, 16.01.2009, http://www.euractiv.com/en/transport/ministers-gather-car-industry-summit/article-178536

[52] "EU support to fight the crisis in the automotive sector", *Europa Press Releases Rapid*, 25.02.2009, the EU official website, http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/318&format=HTML&aged=0&language=EN&guiLanguage=en

[53] " Automobile : le plan d'aide en chiffres », (Automobile: aid plan in figures), *Portail du gouvernement*, *Premier Ministre*, (Portal of the Government, Prime Ministry), the official website, 10.02.2009, http://www.premier-ministre.gouv.fr/chantiers/plan_relance_economie_1393/relancer_secteur_automobile_1397/automobile_plan_aide_chiffres_62595.html

tempted to break the principles because of domestic problems. The French case sat an example to the EU community. The Commission stiffened supervision in other areas as well. In response to the recommendations by the ECB, and the concerns raised by some delegations at the Council of February 9-10, the Commission issued the communication on asset relief measures wherein it laid down the guidelines for designing domestic asset relief schemes. Building on the banking communication of October 2008 (defining the principles for state aids), and on the recapitalisation communication of December 2008 (establishing the principles to recapitalisation of banks) the communication left the design of schemes (including asset purchase, insurance, swap, and guarantee or hybrid models) to member states. However, national schemes would enter into force upon approval by the Commission which would check it against protectionism.[54]

Behind protectionist motives lay domestic problems. In that, social unrest had been escalating in Europe since the beginning of 2009, due to the deterioration of the economic situation, contraction of purchasing power of households, job losses and worsening expectations about future. Strikes and protests were widespread across the continent. Workers, trade unions and farmers in France, Hungary, Latvia, Greece, Germany, Britain, Bulgaria, Lithuania, Slovakia, the Ukraine and Germany protested recession and unemployment. Social costs of the economic downturn urged the heads of states to organise an informal meeting on March 1. The leaders agreed to rely on the single market to support growth and jobs. They approved the communication on the automotive sector, and charged the Commission with assuring effective information sharing about national support schemes. As regards unemployment, they decided to improve the use of the European Social Fund (ESF) and the revised Globalisation Adjustment Fund (GAF) to limit unemployment.[55] On the other hand, the leaders revisited the solidarity commitment, which the next part will develop.

The Spring EC was the major instance to define the guidelines for dealing with the crisis and its social costs. To prepare for the summit, the Commission issued, on

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[54] European Commission, "State aid: Commission provides guidance for the treatment of impaired assets in the EU banking sector", Europa Press Releases Rapid, 25.02.2009, the official website, http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/322

[55] "INFORMAL MEETING OF HEADS OF STATE OR GOVERNMENT OF 1 MARCH 2009: JOINT PRESS LINES", the official website of the Council, Brussels, 1.03.2009, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/misc/106390.pdf

March 4, a communication that addressed, mainly, the real economy and financial stability. As regards the real economy, the Commission set to simplify criteria for support from the ESF, to re-programme spending, and to increase advance payments from early 2009, so as to reinforce active labour market policies. It proposed making changes to the GAF in a way to intervene quickly to provide cash for training and job placement schemes. The communication recommended the extensive use of free movement of workers in remedying the mismatches between skills and labour market needs, as well as the problem of social dumping. The Commission suggested inciting demand for education and training, and developing of 'green jobs'. With regards to the financial sector, the Commission announced the establishment of a new financial supervision system and the release of a Communication on retail investment products, the implementation of measures to reinforce bank depositor, investor and insurance policy holder protection, and measures on responsible lending and borrowing by the end of autumn 2009. Moreover, the Commission set to improve risk management in financial firms and to align pay incentives with sustainable performance, and review the Market Abuse Directive.[56] Thus, the communication conveyed the Commission's intention to improve the regulatory and supervisory frames, and to ameliorate the situation in job markets while respecting the objectives of the Lisbon strategy, that is, promoting competitive knowledge-based economy and safeguarding environmental standards. In so doing, the Commission tried to defend community policies against eventual defection by member states in the context of crisis.

The Ecofin Council in turn, convened to prepare for the Spring EC. After evaluating the economic situation, the Council agreed to take further fiscal measures, namely, reducing VAT in ailing sectors.[57] Other actions before the Spring Council were as follows: The Commission elaborated the impacts of the crisis on pensions, and established that the system was relatively robust in the short run.[58] The ECB decreased interest rates; [59] and the EU signed a Supplemental Memorandum of

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[56] European Commission, "Driving European Recovery", COMMUNICATION FOR THE SPRING EUROPEAN COUNCIL, Brussels, the official website, 04.03.2009, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0114:FIN:EN:HTML.

[57] Council of the European Union, "2931st meeting of the Council", Brussels, 10.03.2009, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/106576.pdf.

[58] "The economic crisis and pensions in the EU", *Europa Press Release*, MEMO/09/99, 06.03.2009, http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/99

[59] European Central Bank, "5 March 2009 - Monetary policy decisions", *Press Release*, the official website, 05.03.2009, http://www.ecb.int/press/pr/date/2009/html/pr090305.en.html.

Understanding of €2 billion with Hungary, on March 11, following the Council decision of November 2008.[60]

At the international level, EU actors participated to the G20 meeting on March 14, 2009. The theme of the summit was social costs of the crisis. The participants stressed to provide assistance to developing economies in turmoil. The countries however, divided over whether to bail out before restructuring. The US and Britain argued in favour of bailing out before restructuring while Germany and France advocated for the contrary. In the end, the G20 decided to augment the IMF's resources through individual contributions, by increasing official borrowing arrangements, or by reviewing quotas. As regards growth, the G20 called on the IMF to assess and guide states in adopting fiscal measures and interest rate cuts.[61] Concerning financial stability, the participants agreed to sustain liquidity support, to recapitalise banks, to tackle impaired assets, and to improve regulation and supervision. Comparing the decisions taken at the international summits such as the G20 or G7 to EU level decisions, it can be inferred that financial stability, unemployment and supervision constitute common concerns worldwide. In addition, both instances chose liquidity provision by central banks to guarantee, recapitalise and resolve financial institutions in dealing with the crisis. These actions were of an unprecedented nature for policy makers.[62] Also, the summit has exposed the divergence of views amongst the big member states, Britain vs. Germany and France so to speak. In other words, the EU could not speak with one voice on the international arena.

The analysis will finally highlight the main decisions taken at the EC of March 19-20, 2009, the Spring Council so to speak. The EU took actions along three lines. With regards to financial solidarity, the EC decided to double the assistance to non-Eurozone countries, also agreed to make the €5 billion of the EERP available for

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[60] European Commission, "EU about to release second instalment of €6.5 billion Community financial assistance to Hungary", Brussels, the official website, 11.03.2009, http://ec.europa.eu/economy_finance/thematic_articles/article14465_en.htm.

[61] "G-20 Asks IMF to Track, Assess Global Crisis Response", *the IMF*, the official website, 14.03.2009, http://www.imf.org/external/pubs/ft/survey/so/2009/NEW031409A.htm

[62] Zoli, "Europe Battles a Deep Recession", *op.cit*.

infrastructure projects and €75 billion for a voluntary loan to the IMF. [63] Towards the financial sector, the EU set to increase regulation and supervision so as to prevent protectionism and maintain competition. In addition, the Council urged the member states to return to their medium-term budgetary objectives and keep to the SGP. In so doing, the EU halted further stimulus measures. As regards unemployment, the leaders set to stimulate labour market by promoting the acquisition of the new skills for new jobs. They decided to improve the use of social protection systems, and of labour mobility.[64] So, at this summit, the EU pursued its already existing strategies. Only in the field of finances, the Council decided to halt fiscal measures.

In sum, in the implementation phase, EU actors mainly addressed three areas; financial stability, the real sector, and international cooperation. In an attempt to boost demand and growth, EU actors (both states and the Commission) prioritised fiscal measures and state aids to ailing financial institutions and sectors. The Commission's assessment of stability and convergence programmes established that the countries that adopted fiscal measures performed better in terms of budgetary discipline than others. This finding, the US bailout plan and social costs of the crisis at home urged governments to take further fiscal measures and aids schemes. However, these measures tended to break the competition rules in the Union, which the French bailout plan to the car industry exemplified. Considering defection, the Commission, backed by the Council, set to tighten supervision in areas like financial operations and support to the real sector. Thus, in a way, what challenged the EU's performance in the implementation phase were protectionist individual actions. Finally, EU actors pursued their efforts at the international level. The analysis identified a similarity between the EU's concerns and strategies, and those of the international instances like G7 or G20. To what extent does this similarity imply that EU level decisions are appropriate for fighting the crisis? Or does the similarity result from the commonality that the interests of the industrialised countries dominate these instances? The next section elaborates on the appropriateness of the EU's strategy for the Union's solidarity at the occasions of the informal meeting of the heads of states of March 1st, and the Spring EC.

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[63] Council of the European Union, "PRESIDENCY CONCLUSIONS", Brussels, 20 March 2009, the official website, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/106809.pdf
[64] *op.cit.*, pp.7-8.

II. IV. THE ISSUE OF INEQUALITY

This section aims to evaluate the relevance of the EU's crisis management strategy in relation to the Union's functioning. In so doing, this part will elaborate the ongoing debate in the EU with regards to the 'more powerful economies (Eurozone economies) vs. the weaker ones (non-Eurozone economies)'.

The issue of inequality between member states has been raised at the occasions of the informal meeting of the heads of states and the Spring EC. At the backdrop of this criticism lay domestic economic problems and the balance of power within the EU.

The crisis has hit the non-Eurozone countries later but harder than the Eurozone members. The next chapter will develop the impacts of the crisis in detail; but it is necessary to give some preliminary information so as to understand the motivations behind the criticism on inequality. In the aftermath of the crisis, exports to Western Europe dramatically declined due to the shrinking purchasing power of the Western households. Moreover, as foreign investors withdrew their money to invest in stronger currencies, local currencies depreciated.[65] Accordingly, foreign debt became more expensive, and budgets made deficits. High budgetary deficit, trade deficit and inflation triggered exchange rate volatility. Currency instability led Western European banks to reduce foreign currency lending. As a result, the non-Eurozone countries suffered from liquidity shortage. Finally, economic slowdown compelled companies to lessen productivity and to make layoffs, if not to close down. So, while unemployment has been climbing and output has been contracting, social policies have become costlier. Governments tended to restrict social spending.[66] Welfare deprivation however, engendered social unrest. It is noteworthy that, not all member states of the region received damages to the same extent. The countries that were the most dependent on foreign investment were the ones that were the worst affected.

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[65] Schneeweiss, Zoe and Magnusson, Niklas, "Banks Face Eastern Europe Downgrades, Moody's Says", *Bloomberg*, 17.02.2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=a7rstGPFeihs&refer=home

[66] Dempsey, Judy, "Currency Issues Weigh on Eastern Europe", *the New York Times*, 17.02.2009, http://www.nytimes.com/2009/02/18/business/worldbusiness/18eastecon.html?_r=1&ref=worldbusiness

Hungary, Latvia and Bulgaria feature in this category. Poland and the Czech Republic better survived the crisis because their economies depended less on foreign lending. In sum, the non-Eurozone members, facing devaluation and liquidity shortage, turned to budget cuts, tax rises, and if not sought financial assistance. Therefore, for these economies, access to foreign currency liquidity has constituted the main challenge.[67] In contrast, the Eurozone countries (except Ireland) profited from monetary supply by the ECB, whereby investing hundreds of billions of euros into public spending, tax cuts, bank bailouts and guarantees to industry. This divergence led Eastern European members to formulate two demands from the Eurogroup.

The first demand came before the informal meeting of March 1st, and pertained to a bailout plan to non-Eurozone countries. In that, financial assistance to Hungary and Latvia had motivated Slovakia, Bulgaria, Romania and the Baltic states to formulate a similar demand, on the grounds that their economy had received greater damage than the Eurozone ones. It is worth noting that Poland and the Czech Republic did not side with the 'Eastern bloc'. Because they were aspiring to join the Eurozone, they denied the need for a region-wide bailout. Hungary requested €25 billion to prevent that "an 'Iron Curtain' be set up and divide Europe into two parts".[68] The Commission and the Eurozone members led by Germany declined the demand on the grounds that Eastern Europe was already receiving funds and loans from the EU, WB and the IMF. After the summit, German Chancellor made its reluctance to pay for the poorer members explicit, "saying that the situation is the same for all Central and Eastern European states, I don't see that. You cannot compare Slovenia or Slovakia with Hungary." [69] The non-Eurozone countries contested the summit outcomes. They criticised inequality in the Union, and accused the Eurozone members of recapitalising domestic companies with bailouts hence reducing competitive advantage of Eastern members.[70] The occasion also prompted the new member states to voice out their dissatisfaction with having been left out of the talks with the US, China and Japan. This discord exposed three things; the

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[67] Zoli, "Europe Battles a Deep Recession", *op.cit.*

[68] Whitlock, Craig, "E.U. Denies Request for Bailout of E. Europe", *the Washington Post*, 02.03.2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/03/01/AR2009030100389.html

[69] Brand, Constant, Associated Press Writer, "Merkel, EU reject bailout for eastern Europe", Yahoo News, 01.03.2009, 4:55 pm ET, http://news.yahoo.com/s/ap/20090301/ap_on_re_eu/eu_eu_summit

[70] Puhl, Jan, "Eastern Europe's Economic Crash", *Spiegel Online International*, 23.03.2009, http://www.spiegel.de/international/europe/0,1518,614960,00.html

vulnerability the EU's solidarity commitment, the divergence of views over the ways of handling the crisis within the EU, and the non-existence of an 'Eastern bloc'.

The second demand came up prior to the EC spring in March 2009. Poland asked facilitated early entry to the Eurozone under the same conditions as the current members, which were allowed to depart from the SGP rules.[71] The demand aimed to resolve the exchange rate volatility problem and to benefit from Eurozone membership. To remind, exchange rate volatility caused trade deficits, budgetary deficits and devaluation. In the aftermath of the crisis, the Polish zloty had fell by 15% against the euro; the Hungarian Forint declined about 13.7% against the euro; the Czech Koruna has slumped by 9.2% and the Romanian Leu by 6.7%.[72] Currency instability triggered serious macroeconomic and social problems. As for Eurozone membership, Eurozone countries enjoyed the ECB's liquidity provisions (in the form of lending and temporary currency swaps) of which non members were deprived. In short, the facilitated early entry the Eurozone would help end currency fluctuations, thereby instil predictability, enable higher stability in planning, and facilitate transactions. The Eurozone countries and the Commission objected to the proposal.[73]

On the other hand, in March 2009, EU actors revised their stance over bailouts to non-Euro area. In that, recession and exchange rate volatility in the region threatened the Eurozone because of the instability risk and heavy investments of some Western European banks in the region. The Austrian banks had the largest market shares; the other investors were Italy, France, Belgium, Germany and Sweden. These banks operated mostly in the Balkan countries, Hungary, Slovakia, Czech Republic, Romania, Croatia and Bulgaria.[74] Interlinks in the banking system had urged the Austrian government to lobby for a €150 million bailout for Eastern European banks prior to the summit. Western European members led by Germany turned the Austrian proposal down. Germany in particular, was reluctant to compensate for the "mistakes

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[71] "Eastern EU members seek shelter from economic storm", *EurActiv,* 20.02.2009, http://www.euractiv.com/en/euro/eastern-eu-members-seek-shelter-economic-storm/article-179614.
[72] Schneeweiss, *et.al. ibid*.
[73] "Eurogroup chief rules out quick easing of euro candidate rules", *EU Business*, 01.03.2009, http://www.eubusiness.com/news-eu/1235906228.19/
[74] "Hungary: The Hungarian Financial Crisis' Impact on Austrian Banks", *Stratfor*, 20.10.2008.

of Austria's banks".[75] On the other hand, prior to the summit, some actors shifted position. France began worrying about the spread of instability over the Euro area. Therefore, France gave support to the Hungarian proposal, and lobbied Germany; but the latter did not mirror the enthusiasm.[76] Further to that, the Commission asked Germany to lift its opposition to the €5 billion package for Eastern Europe. Finally, Luxembourg's PM, also the head of the Eurogroup, argued in favour of financial support due to his concern about escalating mass unemployment and the resulting social problems. On the other hand, Poland and the Czech Republic formed a coalition with Slovakia, Slovenia, Romania, Bulgaria, Lithuania, Latvia and Estonia to dilute the predomination of Western interests at the EC.[77] Hence, the group in favour of bailouts gained in size on Germany on the eve of the summit.

The Spring EC approved the Hungarian proposal. Emphasising solidarity between member states, EU leaders decided to double to the €50 billion financial assistance to non-Eurozone countries facing balance of payments problems. The EU had so far been assisting balance of payment problems through the structural and cohesion funds, the application of reduced VAT, and the EIB actions to boost SME financing possibilities. With the new decision, the EU has overall made up to €30 billion available from resources. However, the clause contained a condition, that is, bailouts would be decided on a case-by-case basis. Thus, the Eurozone refused to acquiesce to a region-wide assistance scheme, the original plan so to speak. In a way, Western Europe again had its interests be accepted by introducing the 'case-by-case basis' clause. So, the decision on doubling the ceiling for assistance could but partly satisfy the Eastern bloc. It is noteworthy that the shift in German position enabled the compromise. Two reasons underlay the German reversal. Firstly, Germany was "a nation reliant on exports"; therefore it needed to contribute to resuscitating the global economy so as to continue exporting.[78] In effect, one major cause behind Germany's approval to financial assistance is that Central and Eastern Europe imports heavily

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[75] Whitlock, Craig, "Banks in Austria Highly Exposed In Eastern Europe", the Washington Post, 19.02.2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/03/18/AR2009031803749.html.

[76] "Early Eastern eurozone entry a must, France warns", *EurActiv*, 06.03.2009, http://www.euractiv.com/en/euro/early-eastern-eurozone-entry-france-warns/article-180026

[77] "Eastern EU members seek shelter from economic storm", *op.cit.*

[78] ""Merkel defends her crisis management", *Spiegel Online International*, 19.03.2009, http://www.spiegel.de/international/germany/0,1518,614296,00.html

from Germany.[79] Secondly, Germany would not agree to bail out for the sake of bankers; it would do so only "to protect the jobs and savings of citizens and to avoid businesses coming to a standstill".[80] In other words, the already existing credit flows on which Germany had agreed accounted for a precaution against an immediate meltdown of the financial system; and they aimed to restore stability of the financial infrastructure.[81] In effect, the German Chancellor, together with the Dutch PM, believed "market driven and social world economy (…) generates (…) confidence and stability".[82] In this vein, the deepening recession in the non-Eurozone economies posed a threat to German priorities. It risked spreading instability over the Eurozone, and aggravating the slowdown of economic activities. In short, macroeconomic concerns led Germany and other members opposing bailouts to reverse their position.

To sum, the EU's crisis management strategy raised the criticism of inequality in the Union in 2009. The non-Eurozone members voiced their dissatisfaction at the occasions of the informal meeting of the heads of states on March 1st, 2009 and of the Spring Council. What prompted this criticism was the rejection of the two demands that the non-Eurozone countries had formulated in February and March 2009, by the Eurozone members and the Commission. The first proposition concerned bailout to non-Eurozone; and the second one pertained to early facilitated entry to Eurozone. At the backdrop of the complaints lay domestic economic problems in Eastern Europe, and the dissatisfaction with the EU's crisis management strategy and the predomination of the interests of Eurozone countries. To remind a finding of the previous sections, the EU's strategy mainly consisted of liquidity provision, of fiscal measures and state aids to ailing institutions and sectors, to boost demand and to maintain the unemployment level. This strategy was appropriate to tackle the impacts of the crisis in industrialised economies, which the similarity between the decisions taken at the EU and those taken at G7 and G20 shows. However, the measures were only partly relevant for the non-Eurozone economies which were deprived of liquidity provision by the ECB, and suffered from exchange rate volatility. As a

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[79] Forelle, Charles, "Pension Glut Lies at Heart of Crisis Wracking Hungary", *the Wall Street Journal*, 25.03.2009, http://online.wsj.com/article/SB123793340762430957.html#mod=fox_australian

[80] Merkel, Angela and Balkenende, Jan Peter, "Values for a Sustainable World Economy", *NRC Handelsblad*, 27.04.2009, http://www.nrc.nl/international/Opinion/article2186062.ece/Values_for_a_sustainable_world_economy

[81] *ibid*.

[82] *ibid*.

result, the new member states felt themselves as ‘second rank’ members despite all institutional and legal arrangements to assure equality and democracy in the Union. The divergence also has exposed the vulnerability of EU solidarity. The augmentation of financial assistance to non-Eurozone only party rectified the image, because aids were conditioned to approval on a case-by-case basis. This clause conveyed that the Eurozone countries had their interests accepted at the EU level. Moreover, the decision to increase the ceiling for aids schemes resulted from the macroeconomic concerns of the old member states, namely those of Germany and France, and not veritably from non-Eurozone lobbying. On the whole, the discord has proved that state interests prevail in the EU. Of the member states, the interests of the Eurozone members, and those of France, Germany, Britain and Italy in particular, dominate EU level decisions. The Eurozone members are not keen on financial solidarity when their interests are at stake. Also, a solid ‘Eastern bloc’ does not exist, which the lack of Polish and Czech support to the Hungarian proposal demonstrates. However, it tends to come about when these countries want to counterpoise ‘Western domination’ as the latter name it. Finally, the EU’s strategy may be relevant for an industrialised country but it is handicapped for a Union that is composed of both the industrialised and developing countries.

To recap, this chapter has examined the impacts of the crisis on European economies and EU actors’ actions and responses to face them. The analysis covered the period from September 2008, when the crisis broke out, to the end of March 2009 when the Spring EC took place.

The first section tracked the outbreak of the crisis and the immediate responses of the member states. The analysis identified that the crisis touched the Eurozone economies first, because their banking sectors were more integrated into the international financial system than the others. The states initially took unilateral actions to contain the damages; but economic interdependence urged them to take multilateral actions and enhance cooperation. The initiative to develop a common action plan emerged in October 2008. In this period, EU actors also made the commitment of solidarity between member states. The initiatives began by the emergency meeting between Britain, France, Germany and Italy. The leaders

discussed the strategy to take in fighting the crisis. The decisions reflected on the following EC and Council meetings where the EU defined the guidelines for a common EU strategy. In other words, the EU's orientations have stemmed from the four influential members rather than the EU-27. Following the summits, the EU first, allowed state aids to distress the banking sector. Then, the Commission implemented the defined guidelines in the EERP. In the mean time, the EU actively partook in the international efforts to restructure the global financial system.

In the implementation period, the EU took actions along three lines, financial stability, the real sector and international cooperation. In so doing, it faced the problem of regulation due to the disparate natures of the rescue packages. The French bailout plan to the car industry has demonstrated that when nation interests are at stake, member states tend to breach the competition rules. On the other hand, the analysis established that the EU's crisis management strategy mostly targeted the Eurozone economies. However, EU actions overlapped with G7 and G20 actions.

The final section elaborated the appropriateness of EU strategy for the Union through the cases of two demands by the non-Eurozone countries. The non-Eurozone group asked bailout and early facilitated accession to Eurozone. The partial relevance of EU level actions to their domestic problems and the dissatisfaction with being left out of decision making process motivated the demands. The Commission and the Eurozone members turned the requests down. The rejections prompted the argument of inequality within the Union. The analysis identified that the old Eurozone members revised their position at the Spring EC for macroeconomic concerns. The decision of doubling aid scheme could only partly satisfy the non-Eurozone countries, because assistance was conditioned to an evaluation on a case-by-case basis. This finding conveys that the Eurozone interests again overweighed the non-Eurozone concerns.

On the whole, the chain of events has demonstrated that the interests of Britain, France, Germany and Italy in particular, are predominant in the Union. This pattern which had been present prior to the Eastern enlargements has not altered with institutional reforms. In other words, the accession of large Eastern European countries did not change the balance of power within the Union. Also, the crisis has

shown the inappropriateness of the EU's crisis management strategy for a Union composed of both industrialised and developing countries. Moreover, the crisis has exposed the vulnerability of EU solidarity. The issue of inequality, because it challenges solidarity in the Union, requires rethinking the future of the integration with 27 members. Finally, the analysis infers that social implications of the crisis are likely to be bothering the EU in the medium and long term, unemployment in particular. Social problems are of a critical nature for the new member states, because they risk challenging support to the EU, the legitimacy of national governments, but more importantly public trust in the efficiency of the EU's liberal economy. The performance of welfare state in alleviating social costs is crucial in this regard. The next chapter will analyse the social costs of the crisis and the measures to counter them in the context of the EEC.

CHAPTER III

THE MACROECONOMIC IMPACTS OF THE CRISIS ON CENTRAL AND EASTERN EUROPE

This chapter develops social and economic impacts of the crisis in Central and Eastern Europe. The chapter is structured in two sections. The first one analyses the macroeconomic performances of the new member states from the pre-accession period to the outbreak of the crisis. The second part dwells upon the impacts of the macroeconomic impacts of the crisis in the region. The objective in this chapter is to comprehend whether the crisis has caused damages at different levels across the region, thereby to test the validity of the German argument. The analysis covers the period from pre-accession to the aftermath of the crisis. Data is collected from official reports and working papers by the EU, the IMF and the WB, as well as from articles, and analyses in the media.

III. I. Accession and Adjustment to the EU Policies

This section elaborates on the macroeconomic impacts of EU accession in Central and Eastern European countries. The objective is to understand the extent to which the pre-accession process and experiences with membership have engendered similar conditions. So doing will help comprehend whether these countries were at the same level when they faced the crisis.

It has become widespread to use the denomination of the 'EEC' or 'CEEC' to designate the countries of Central and Eastern Europe. This abbreviation gives a delusive impression that these countries are alike. However, not only these countries display different ethnic, economic and political characteristics, but also, they are dissimilar in terms of their economic and political performances in the EU. Their varied performance during the pre-accession process had led the Commission to regroup them as the first and second wave candidates. This thesis will designate them as the new member states (NMS), by, of course, leaving Cyprus and Malta out; also,

occasionally, C5 will stand for Hungary, Poland, the Czech Republic, Slovakia and Slovenia.

Notwithstanding disparities, the NMS followed some trends. To put it bluntly, the EU accession process has spurred growth and development in the region. First of all, the opening to international markets has channelled a greater amount of goods and services, and foreign capital into these economies. Trade opening has increased knowhow, and has enabled local firms to get support from Western companies. Secondly, integration to EU market has spurred trade, foreign direct investments (FDI), and growth and decline in poverty thereof.[83] Absolute poverty has declined in almost all NMS.[84] In the last five years, "the region's annual real GDP growth has averaged close to 6%, accelerating the recovery that had started in the late 1990s".[85] It is noteworthy that growth stemmed from technological progress, "rapid credit growth and a consumption boom financed by foreign currency borrowing" in the region.[86] Labour made a modest, if not a negative contribution to growth.[87] In effect, immigration outweighed emigration in most NMS; the shortage of skilled labour has emerged therefrom. Immigration rate was particularly high for Latvia, Lithuania, Bulgaria, Romania and Poland.[88] The countries that recorded higher growth rates were the ones that had greater capital accumulation and technological progress.[89]

Thirdly, financial integration to the EU has channelled a considerable amount of credit towards NMS economies thanks to favourable political conditions and low interest rates. Credit flows came in the form of FDI, bank loans and portfolio investment. They caused two sorts of problems. First of all, these "flows have

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[83] Cihák, Martin and Fonteyne, Wim, "Five Years After: European Union Membership and Macro-Financial Stability in the New Member States", IMF Working Paper, the IMF official website, 01.03.2009, http://www.imf.org/external/pubs/cat/longres.cfm?sk=22810.0, p.6.

[84] World Bank, "Growth, Poverty and Inequality. Eastern Europe and the Former Soviet Union", the official website, 2005, Washington: World Bank, http://siteresources.worldbank.org/INTECA/Resources/complete-eca-poverty.pdf, p.25.

[85] Vamvadakis, Athanasios, IMF European Department, "Emerging Europe Closes Income Gap with Advanced Europe", *IMF Survey Magazine*, Countries & Regions, the IMF official website, 01.08.2008, http://www.imf.org/external/pubs/ft/survey/so/2008/CAR080108C.htm

[86] World Bank, "Global Crisis Pushing Almost 35 Million People Back Into Poverty And Vulnerability In Europe And Central Asia", the official website, Press Release No:2009/323/ECA, 25.05.2009, http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:22155627~pagePK:34370~piPK:34424~theSitePK:4607,00.html

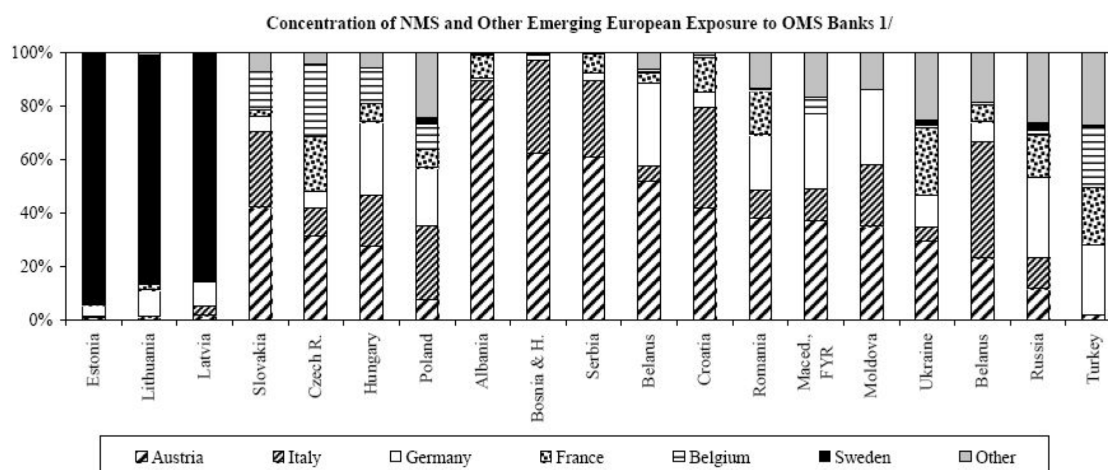
[87] Cihák, and Fonteyne, *op.cit.*, p.18.

[88] IMF, "Regional Economic Outlook, Europe Dealing With Shocks", *World Economic and Financial Surveys*, October 2008, the official website, http://www.imf.org/External/Pubs/FT/ REO/2008/EUR/ENG/ereo1008.pdf

[89] Cihák, and Fonteyne, *op.cit.*, p.18.

financed activities in the non tradable sectors and have contributed to overheating of the economies: the larger the capital inflows, the stronger the demand boom, the greater the overheating of the domestic economy and the larger the widening of the current account deficit".[90] Secondly, as seen in Table I, Western European banks, especially from Austria, Sweden and Italy, made huge investments in the NMS banking sector.[91] These banks undertook operations in the form of foreign currency lending (which consisted of offering mortgages, personal loans and business loans in euros and Swiss francs).[92] This practice was particularly widespread in the Balkan countries, Hungary, Slovakia, Czech Republic, Romania, Croatia and Bulgaria.[93] However, such operations bore the risk of bloating external debts, causing budgetary imbalances because of currency mismatches. Currency mismatches rendered private sector vulnerable to exchange rate depreciation.[94] So, credit inflow has amply contributed to growth, but also to external debts and risk taking in some NMS.[95]

Table 3.1.1



Source: BIS Quarterly Review, December 2007.
1/ Emerging Europe exposure to Western European banks is defined as the share of the reporting banks in each Western European country in the total outstanding claims on a given emerging European country (bank and nonbank sectors).
2/ Western European banks' exposure to emerging Europe is defined, for each Western European country, as the share of each emerging European country in the total outstanding claims of the reporting banks in that Western European country.

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[90] IMF, "Regional Economic Outlook, Europe Addressing the Crisis", *World Economic and Financial Surveys*, May 2009, the official website, http://www.imf.org/external/pubs/ft/reo/2009/EUR/eng/ereo0509.pdf, p.62.
[91] Of the Austrian banks, Raiffeisen, Erste Bank, Volksbank, BAWAG P.S.K. and Bank Austria Creditanstalt (also part of the Italian UniCredit Group) had expanded their operations so much that they "dominated claims in inter-bank lending and short-term money market instruments in the EEC banking sector, and their total claims summed up to, approximately, 40% of local GDP. Besides, Austrian banks received 35% of their profits in this region. The overall Austrian bank exposure to the region amounted to nearly $300 billion in 2008." "Hungary: The Hungarian Financial Crisis' Impact on Austrian Banks", *op.cit.*
[92] *ibid*.
[93] Cihák, and Fonteyne, *op.cit*., p.33.
[94] Haas, François and Tamirisa, Natalia, "Euro Area Policies: Selected Issues", IMF Country Report, *the IMF*, No: 07/259, Washington: IMF, 10.07.2007, http://imf.org/external/pubs/ft/scr/2007/cr07259.pdf, p.29.
[95] Kodres, Laura, IMF Monetary and Capital Markets Department, "Credit Crisis Is Broadening, IMF Warns", *IMF Survey Magazine*, IMF Research, Global Financial Stability Report, the IMF official website, 08.04.2008, http://www.imf.org/external/pubs/ft/survey/so/2008/RES040808A.htm

Fourthly, EU accession has improved price stability in the NMS.[96] To meet the EU accession criteria, the NMS followed anti-inflationary policies. However, the intense credit flow by putting pressure on prices challenged these attempts. The other factors causing inflation were productivity growth (which increased wages, prices of goods and services), and the exchange rate regime (the countries that opted hard peg,[97] such as Bulgaria, the Baltic States, Poland and the Czech Republic, recorded a higher level inflation than others).[98] On the other hand, the choice of exchange rate regime played an important role in meeting the criteria for entering the Eurozone. Cihák and Fonteyne's study conveyed that "inflation targeting countries were more likely to meet the criterion while those with hard pegs were less likely to do so; and also, countries with higher GDP per capita and higher degrees of central bank independence were more likely to satisfy the criterion".[99] A final factor that facilitated the entry to the Eurozone was political commitment to deliver the necessary reforms.

The favourable trends however, have begun undergoing a downward pressure by 2008. The IMF report of *Regional Economic Outlook* of April 2008 stated that growth rates were decelerating due to trade and financial openness.[100] The IMF identified a greater risk for the countries that depended on foreign capital and that were facing balance of payment problems. The IMF's forecast has turned out to be accurate in the aftermath of the crisis; Hungary, Latvia, Bulgaria and Lithuania, whose economies were the most dependent on foreign investments, were the ones to be the worst damaged by the crisis. Three other factors challenged growth in the period preceding the crisis; the rising inflation resulting from the developments in commodity markets, unemployment and regional disparities.[101] Despite vulnerabilities, the IMF saw growth potential in some countries of the region.

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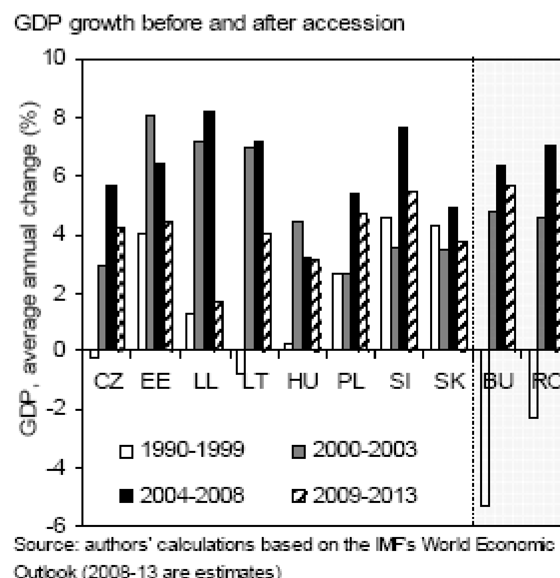
[96] Cihák, and Fonteyne, *op.cit.*, p.21.
[97] "Establishing a fixed exchange rate between one national currency (usually that of a small country) and another national currency (usually that of an industrial power)", "Hard Peg", *Amoss Web*, http://www.amosweb.com/cgi-bin/awb_nav.pl?s=gls&c=dsp&k=hard+peg
[98] Cihák, and Fonteyne, *op.cit.*, p.22.
[99] *op.cit.*, pp.22-23.
[100] Zoli, Edda, "Resilient Europe Faces Further Test", *IMF Survey Magazine*, Countries & Regions, the IMF official website, 21.04.2009, http://www.imf.org/external/pubs/ft/survey/so/2008/CAR042108A.htm
[101] *ibid.*

Fifthly, the EU contributed to growth and development in the region by pressuring reforms and providing financial assistance. In the pre-accession period, the Commission compelled governments to fulfil the scheduled reform list through the conditionality, timing and benchmarking. The accession perspective has urged governments to undertake the reforms quicker than otherwise. After accession, the eventuality of changeover to euro has urged governments to follow sounder fiscal and budgetary policies. Also, the Lisbon Agenda has forced governments to adopt structural reforms. Even if no NMS government could attain the Lisbon objectives, they ameliorated their performance with regards to employment and social policies. Concerning financial assistance, the EU has been helping the NMS to close the income gap by funding public infrastructure projects, employment policies and private firms (for restructuring) within the framework of the cohesion policy. The Union also has been offering direct income support to households through the Common Agricultural Policy.[102] These initiatives have significantly improved the living conditions in the NMS; but have not sufficed to shift them to the level of their Western neighbours.

Table 3.1.2



Despite commonalities, the NMS displayed significant disparities. Table 3.1.2 shows that between 2000 and 2008, Baltic economies showed the best performances

[102] Allard, Celine, IMF European Department, "Large EU transfers could speed catching up process", *Survey Magazine*, Countries & Regions, the IMF official website, 01.08.2008, http://www.imf.org/external/pubs/ft/survey/so/2008/CAR080108B.htm

amongst the NMS.[103] According to the IMF statistics, Lithuania, Latvia and Estonia had the highest growth rates in Europe from 2000 to 2006. The growth rates peaked in 2006; the percentages were 11.2% for Estonia, 11.9% for Latvia and 7.5% for Lithuania. [104] In all three countries, growth was driven by domestic demand, investments (propelled by income growth), rapid credit expansion and stimulus from EU funds.[105] Private consumption was sustained by wage increases. Growth rates began decelerating in 2007 as a result of faltering private consumption and anti-inflationary policies aimed to end the price boom in mortgages and in the real estate market.[106] In Estonia, growth faltered also because of a decline in net exports.[107] In the Baltic states, domestic demand sustained as a result of the credit and housing booms. Strong private consumptions triggered high inflation in these countries.[108] With regards to the labour market, employment rates improved significantly; unemployment dropped, in 2009, to 5.6 in Latvia[109], to 4.9 in Estonia[110] and to 4.4 in Lithuania.[111] Growing employment tightened labour market; these countries suffered from skilled labour shortage. To remind, these countries had had significant levels of emigration after the accession, which created labour shortage, and put pressure on wages. These developments prompted external and internal imbalances with significant threats to financial stability.[112] But hopefully, the Baltic states had greater fiscal stability, higher transparency, and a sounder banking system owing to better supervision and affiliations to foreign banks. They nevertheless were vulnerable because of rapid credit expansion. In that, most credit flow came in foreign exchange and banks were taking on increasing exposures to real estate, which brought

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[103] Cihák and Fonteyne, *op.cit.*, p.10.
[104] IMF, "World Economic Outlook Data Base: April 2009", the official website, April 2009, http://www.imf.org/external/pubs/ft/weo/2009/01/weodata/weorept.aspx?sy=2000&ey=2010&scsm=1&ssd=1&sort=country&ds=.&br=1&c=941%2C946%2C939&s=NGDP_RPCH&grp=0&a=&pr1.x=64&pr1.y=15
[105] IMF, *Estonia*, Country Brief, *the World Bank*, the official website, April 2009, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/ESTONIAEXTN/0,,menuPK:301083~pagePK:141132~piPK:141107~theSitePK:301074,00.html; IMF, *Latvia*, Country Brief, *the World Bank*, the official website, April 2009, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/LATVIAEXTN/0,,menuPK:361565~pagePK:141132~piPK:141107~theSitePK:361470,00.html; IMF, *Lithuania*, Country Brief, *the World Bank*, the official website, April 2009, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/LITHUANIAEXTN/0,,menuPK:304965~pagePK:141132~piPK:141107~theSitePK:304956,00.html.
[106] European Commission, "European Economy, Economic Forecast Autumn 2007", No:7-2007, the official website, http://ec.europa.eu/economy_finance/publications/publication9979_en.pdf, pp.73-74, 90-93.
[107] "European Economy, Economic Forecast Autumn 2007", *op.cit.*, p.74.
[108] *Estonia*, *Latvia and Lithuania*, Country Brief, *op.cit.*
[109] *Latvia*, Country Brief, *op.cit.*
[110] "European Economy, Economic Forecast Autumn 2007", *op.cit.*, p.74.
[111] *op.cit.*, p.93.
[112] *Estonia*, *Latvia and Lithuania*, Country Brief, *op.cit.*

substantial risks to the banks' asset quality, their performance of reserve coverage from short-term debt[113], and financial stability.[114] Foreign credits also augmented external debt. As regards public finances, Estonia and Latvia had budgetary surpluses resulting from high growth, employment rates and revenues. Estonia displayed the lowest level of public debt in 2007 across the EU.[115] Only in Lithuania, budget made deficit after the accession; and that because of insufficient tax revenues. The deficit widened in 2008 due to tax and pensions reforms.[116] The Baltic performance was superior to others thanks to some additional benefits; the relatively slower population growth, and their proximity of Nordic markets and Russia (while C5 markets were oriented to Germany and its neighbours).[117] Finally, the Baltic States retrenched public sector, and managed to attract foreign direct investment owing to their greater integration in international trade and more flexible labour markets.

The Baltic performances were outstanding; and yet Slovenia and Slovakia managed to join the Eurozone. Slovenian and Slovakian successes owed to low deficits and debt levels, as well as political determination to adopt euro. The government's commitment to changeover to euro was backed up by a favourable political opinion in Slovenia. In 2006, "Slovenia had the highest ratio of respondents who were emotionally ready for the replacement of their national currency (72%, +8), followed by Slovakia (55%, +1)".[118] In Slovakia however, public, although high, was not one of the most acquiescent to the adoption of euro amongst the NMS; in 2008, the percentage of the citizens who were happy about the changeover was 52% (vs. 43% unhappy) while the scores were 62% (vs. 21%) in Romania and 59% (vs. 31%) in Latvia.[119]

Slovenia distinguished from other NMS by its relatively greater prosperity. This comparative advantage has created a favourable environment for reforms in the country. Governments carried the reforms out in consensus by the political elite and

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[113] Schadler, Susan et al. "Growth in the Central and Eastern European Countries of the European Union", Occasional Paper 252, Washington DC, IMF, 2006, http://www.imf.org/external/pubs/nft/op/252/op252.pdf, p.4.
[114] *Estonia*, *Latvia and Lithuania*, Country Brief, *op.cit.*
[115] "European Economy, Economic Forecast Autumn 2007", *op.cit.*,p.74.
[116] *op.cit.*, p.93.
[117] Schadler, *et al., op.cit.,* pp.1-3.
[118] European Commission*,* "Introduction of the Euro in the New Member States", Fieldwork September 2006, the EU official website, http://ec.europa.eu/public_opinion/archives/eb/eb69/eb_69_first_en.pdf, p.37.
[119] European Commission, "Introduction of the Euro in the New Member States", Fieldwork May 2008, the EU official website, http://ec.europa.eu/public_opinion/flash/fl_237_en.pdf, p.42.

people. In contrast, public in the poorer NMS appeared less eager to undertake EU reforms with unpopular policy consequences.[120] Slovenia significantly improved its economic performance in the period from 2004 to 2008, after the accession so to speak, owing to sound fiscal policies. Rapid growth was driven by gross capital formation and household consumption. Output by the manufacturing sector also contributed to growth performance. On the other hand, Slovenia had a negative score on net exports due to high import growth after accession.[121] Fiscal discipline enabled low deficits and debts levels, as well as low inflation.[122] The country displayed the lowest debt level amongst the NMS in 2005.[123] Thanks to this performance, Slovenia became the first new member to access the Eurozone in January 2007. On the other hand, the banking sector remains underdeveloped. According to IMF Report on Slovenia, the sector comprises a few large state-owned banks with low profitability. Besides, the banks largely rely on foreign investments and loans from Western European banks. In an attempt to increase profits, banks have been augmenting operations in the region, thereby rising their vulnerability to interest rates and funding risks.[124]

Slovak economy made a leap forward after accession. In 2006, "real GDP grew by 8.5%, and inflation accelerated to 4.5%".[125] The growth has pursued its acceleration till the advent of the crisis. The growth was propelled mainly by domestic demand, gross fixed capital formation in the construction and infrastructure sectors, and partly by exports. High level of wages and employment growth sustained private demand. In 2007, the country featured a trade surplus.[126] Fiscal deficit in 2006 rose to 3.4% of GDP due to pension reform that the government delivered in preparing for elections.[127] Sustained growth in Slovakia increased tax revenue in 2007 and 2008 whereby the government managed to narrow down budgetary deficit.

[120] World Bank, *Slovenia*, Country Brief, the official website, September 2008, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/SLOVENIAEXTN/0,,menuPK:305287~pagePK:141132~piPK:141107~theSitePK:305278,00.html
[121] "European Economy, Economic Forecast Autumn 2007", *op.cit.*, p.112
[122] *Slovenia*, Country Brief, *op.cit.*
[123] Tuladhar, Anita et. al., "Republic of Slovenia: Selected Issues", IMF Country Report No. 07/182, the official website, 02.05.2007, http://www.imf.org/external/pubs/ft/scr/2007/cr07182.pdf, p.59.
[124] *op.cit.*, p.6.
[125] World Bank, *Slovakia*, Country Brief, the official website, September 2008, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/SLOVAKIAEXTN/0,,menuPK:305126~pagePK:141132~piPK:141107~theSitePK:305117,00.html
[126] "European Economy, Economic Forecast Autumn 2007", *op.cit.*, pp.114-115.
[127] *Slovakia*, Country Brief, *op.cit.*

Accordingly, Slovakia fulfilled the SGP criteria, and joined the Eurozone on January 1st, 2009.

The Czech Republic displayed one of the highest income levels in the Union, net exports, low levels of inflation, fiscal consolidation, strong balance of payments, and foreign direct investments amounting to approximately to 50% of GDP.[128] "The real GDP growth rose from 1.9% in 2002 to over 6% in the years 2005-7".[129] Consumer demand, investments, FDI and exports have propelled growth. In addition, wages and social benefits have improved, whereby sustaining private consumption. Unemployment has tended to slump, while inflation was kept under control.[130] Growth occurred mainly in manufacturing sector, but also in electronics and the car industry. Czech economy attracted FDI in its industries and particularly in the sectors where foreign-affiliated companies are dominant. In 2008, growth levels slightly fell while budgetary deficit tended to rise due to fiscal measures undertaken in view of meeting the SGP criteria. To this end, the country reduced social spending.

Poland's economic performance improved from the pre-accession period to 2008, as shown in the table. In 2007, real GDP growth attained 7.1%.[131] Private consumption and investments triggered growth, respectively by 6% and 25.3%.[132] FDI and credit flows also have contributed to growth. Wage increases and improvements in the labour market sustained consumption, thereby growth. The country witnessed the rise of both exports and imports in this term. On the other hand, by 2008, growth tended to decelerate due to shrinking exports (resulting from faltering external demand) and rising investment.

Hungary is the only country whose growth rate worsened from the period from the pre-accession to the accession period. In 2007, growth made a significant drop (scoring 0.1% in the second quarter of 2007) as a result of government's consolidation efforts. The main motors of growth were private consumption, exports, EU funds and foreign investments. In Hungary, private consumption contracted in

[128] World Bank, *The Czech Republic*, Country Brief, the official website, September 2008, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/CZECHEXTN/0,,menuPK:304643~pagePK:141132~piPK:141107~theSitePK:304634,00.html
[129] *ibid*.
[130] "European Economy, Economic Forecast Autumn 2007", *op.cit.*, p.66.
[131] *op.cit.*, p.105.
[132] *ibid.*

contrast to the augmentation of exports to Western Europe and foreign investments.[133] It is noteworthy that foreign investments have buttressed the country's vulnerability due to the risk of capital outflow. This risk has come true after the crisis. In addition, foreign capital contributed to current account and fiscal deficits. Budgetary deficit peaked in 2006 (9.2%).[134] Accordingly, the government introduced fiscal measures, and retrenched public sector. Fiscal discipline policies however, have decreased growth.[135]

Bulgaria and Romania joined the EU in 2007. EU accession perspective underlies the amelioration of economic performance from the period 2000, 2004 to the period between 2004, 2008. Both countries are middle income countries with gross national income per capita being, US$ 6150 in 2007 for Romania, and US$ 5490 in 2008 for Bulgaria.[136] These scores lag behind the EU average. Romanian growth rose to 7.7% in 2006. The propellers of growth in Romania were private consumption, gross fixed capital formation and exports. Consumption was sustained by wage raises and high domestic credit availability.[137] On the other hand, domestic demand, by fuelling imports, put pressure on the trade deficit. In the pre-accession period, Romania attracted a significant amount of FDI owing to privatisations. After 2007 however, privatisations decelerated, thereby foreign capital inflow in the country has slowed down. Romania displayed budget deficit around 2.7% in 2007, and was expected to further rise before the outbreak of the crisis. The reason propelling budget deficit was the increase in government consumption which stemmed from pay rise in the public sector and social transfers. The expansion of budget deficit mirrored as the deterioration of debt-GDP ratio.[138] On the other hand, growth increased from 2003 to 2006. Like in Romania, growth in Bulgaria was spurred by FDI, credit growth, investments and domestic demand. Similar to Romania, wage increases and employment sustained private consumption. After

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[133] *op.cit.*, p.96.
[134] *ibid*
[135] World Bank, *Hungary*, Country Brief, the official website, October 2008, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/HUNGARYEXTN/0,,menuPK:302090~pagePK:141132~piPK:141107~theSitePK:302081,00.html
[136] World Bank, *Bulgaria*, Country Brief, the official website, April 2009, http://www.worldbank.bg/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/BULGARIAEXTN/0,,menuPK:305448~pagePK:141132~piPK:141107~theSitePK:305439,00.html; World Bank, *Romania*, Country Brief, the official website, April 2009, http://www.worldbank.org.ro/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/ROMANIAEXTN/0,,contentMDK:20636934~menuPK:287302~pagePK:141137~piPK:141127~theSitePK:275154,00.html
[137] "European Economy, Economic Forecast Autumn 2007", *op.cit.*, p.110.
[138] *op.cit.*, pp.110-111.

2003, growing FDI flows also contributed to growth. FDI inflow, together with the re-acceleration of credit growth propelled investment demand.[139] FDI targeted mainly the manufacturing, finance, construction and real estate sectors.[140] Expansion in these sectors partly improved the employment level. Unemployment persisted; and has generated wage pressures. Besides, rising inflation tightened the labour market, and has caused high skilled labour shortage.[141] It is worth reminding that the country's trade deficit shifted from 14.9% in 2004 to 23.8% in 2008. On the other hand, budgetary balance improved from 2004 (2.3) to 2008 (3.1). Having established the main characteristics of NMS economies, Table 3.1.3 resumes what has propelled growth in each country. So doing will facilitate to understand, in the next part, how the crisis has added to the vulnerabilities in each economy.

Table 3.1.3

Country	**The propellers of Growth**					
	private consumption	**investments**	**credit flow/FDI**	**exports**	**EU funds**	**Gross fixed capital**
Baltic States	X	X	X		X	
Slovenia	X					X
Slovakia	X	X				
Czech Republic	X	X	X	X		
Poland	X	X	X			
Hungary	X	X		X	X	
Bulgaria	X	X	X			
Romania	X	X		X		X

This section examined the NMS performances after the accession. The analysis established that all NMS underwent the same external impacts. EU integration benefited to all NMS in terms of growth, fiscal and budgetary positions, and the development of social policy standards. On the other hand, the NMS amply varied from one another. The disparity begot from the difference in their initial economic situation, as well as from the difference between political and social characteristics. Slovenia for instance, had relatively greater prosperity; and the latter has eased the adoption of reforms. In addition, Slovakian and Slovenian governments were more committed to join the Eurozone than others. As a result, despite the outstanding performances by the Baltic states, Slovakia and Slovenia managed to join the Eurozone earlier than others after having rectified their budgetary positions. On the other hand, this section identified vulnerabilities in the countries with greater amount of debts in foreign currency. In addition, the NMS experiencing housing booms

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[139] *op.cit*., p.64.
[140] World Bank, *Romania*, Country Brief, the official website, April 2008, http://www.worldbank.bg/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/BULGARIAEXTN/0,,menuPK:305448~pagePK:141132~piPK:141107~theSitePK:305439,00.html
[141] "European Economy, Economic Forecast Autumn 2007", *op.cit*., p.64.

suffered from speculations. Finally, the NMS whose growth was triggered by exports to Western Europe appeared to be sensitive to the fluctuations in the purchasing power of households in the Western region. So, having established the particular vulnerabilities in the NMS, the next section proceeds to the analysis of the impacts of the crisis.

III. II. The Impacts of the Crisis on Central and Eastern Europe

This section elaborates on the macroeconomic implications of the crisis. The objective is to see how the common adversities engendered by the financial crisis have added to the domestic vulnerabilities.

To remind some findings of the previous chapter, the crisis emerged in the financial sector. The deterioration of the financial situation has worsened expectations, hence causing liquidity shortage and uncertainty. "Tighter financial conditions, falling wealth, and greater uncertainty have triggered a sharp decline across all types of demand".[142] Following plunging global demand, commodity prices and trade have contracted. Accordingly, inflation fell, investments and exports therefrom. Due to the interconnection with the financial system, the real economy also has been upset; firms began closing down; layoffs have escalated. In short, the world economy has fallen into recession. Industrialised economies received the impacts of the crisis earlier than emerging economies because of their greater exposure to the international finance and trade systems.[143] The EU follows the pattern.

Across the Union, output and trade have fallen, thereby prosperity. Due to the diminution of global demand, European economies are unlikely to rely on trade for recovery in the medium term. In the finance sector, the lack of confidence has hindered risk taking. As a result, the cost of capital is expected to remain high in the immediate future, which raises concerns about liquidity shortage. Accordingly, the risk of capital outflow has increased for the economies depending on foreign capital.

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[142] Zoli, "Europe Battles a Deep Recession", *op.cit*.
[143] "Regional Economic Outlook, Europe Addressing the Crisis", *op.cit.*, p.8.

In addition, even if all economies faced disinflation, the challenge seems to be greater for the countries with fixed exchange regimes.[144] The countries with high external debts have received heavy damages. Also, the crisis has deflated housing booms; and has worsened account deficits. Having established the EU-wide patterns of the crisis, let us now focus on the NMS specific implications.

The crisis has grasped the NMS via Western Europe. It has arrested credit-fuelled growth in Central and Eastern Europe.[145] "Downturn was triggered by the global financial crisis and the sharp drop in trade".[146] So, all NMS have undergone decline in output and in stock prices, increases in sovereign bond spreads, and devaluation.[147] One reason behind these phenomena was the rise of "credit-default swaps on sovereign debts", which in turn, has triggered the risk of default in the region.[148] In response to this risk, Western banks having investments in the region curtailed foreign currency lending. This restriction, by causing liquidity shortage, has unsettled the domestic interbank money markets, thereby generating depreciation. Some local banks have collapsed in the process, while others have become dependent on Western banks for financing. On the other hand, as the banks became stricter in granting loans, customers began paying late. Accordingly, economic activity decelerated; thereby unemployment has begun escalating.[149] Another source of vulnerability was high current account deficit. Account deficit has worsened the countries' riskiness for lending to them, as well as the cost of borrowing for them. As was established in the previous section, NMS economies displayed wider current account deficits, external debts, higher inflation and greater dependence on credit flow. Given these vulnerabilities, the NMS received greater damages by the crisis than the Eurozone economies.[150] On the other hand, damages occurred at different levels. In sum, interlinks with Western Europe that once had contributed to growth have proved a source of vulnerability for the NMS, by aggrandising risk exposure in

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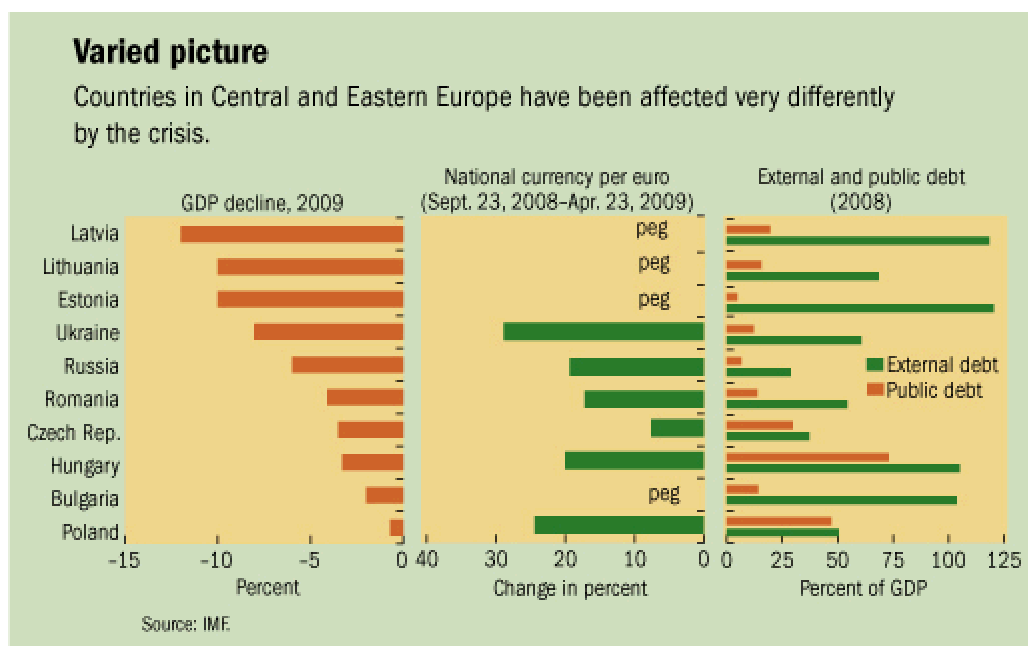
[144] *ibid.*
[145] "The Ties that Bind", *the Economist,* 19.02.2009, http://www.economist.com/opinion/displaystory.cfm?story_id=13145857
[146] IMF, "Financial Sector Key to European Recovery", *IMF Survey Magazine,* 24.04.2009, the official website, http://www.imf.org/external/pubs/ft/survey/so/2009/car042409c.htm
[147] "Regional Economic Outlook, Europe Addressing the Crisis", *op.cit.*, p.56.
[148] "The Ties that Bind", *op.cit.*
[149] Dempsey, *op.cit.*
[150] "Global Crisis Pushing Almost…", *op.cit.*

the region. Having established the common characteristics, let us now see how these implications have diffused into the NMS.

The IMF thesis is that the extent to which the NMS have withstood the downturn depended on whether they had sound macroeconomic policies before the crisis.[151] Macroeconomic stability designates low inflation, little fiscal deficit and low external debts. Secondly, the extent to which governments could cope with inflationary pressures and account deficits (stemming from capital inflows) before the crisis is another structural determinant of good crisis management. Thirdly, the use of the flexible exchange rate helps better control inflation. Finally, the countries, especially those of a smaller size, where growth resulted from exports to Western Europe are affected by the shrinking purchasing power of Western European households. Table 3.2.1 displays the impacts of the crisis across the NMS.[152] This section proceeds with an analysis of member states' economies so as to pinpoint the country-specific disparities.

Table 3.2.1



Of the NMS, Slovenia and Slovakia have been cushioned by the crisis owing to their better regulated and sounder banking sectors, as well as Eurozone membership. In Slovakia, the crisis has produced little impact on the banking system; no rescue

[151] "Regional Economic Outlook, Europe Addressing the Crisis", *op.cit.*, p.67.
[152] "Financial Sector Key to European Recovery", *op.cit.*

operations have taken place. The crisis has yet deteriorated exports, domestic demand, output, budgetary deficit and inflation. Due to shrinking purchasing power of Western households, exports fell by 30% in January, and output in the manufacturing industry by 32.7%. Especially, the car industry has been damaged.[153] In addition, private consumption has faltered due to diminishing inflation and pension indexation. Likewise, investments have plunged as a result of slowing economic activity, tighter credit conditions and deteriorating investor sentiment. Accordingly, "growth is expected to contract by around 2.5% in 2009 and to slightly rebound by ¾ in 2010.[154] Furthermore, the crisis has augmented government deficits. Even so, the Commission predicts for Slovakia the highest growth within the EU. Also, Slovakia displays the best credit rating.[155] On the other hand, in Slovenia, the crisis has manifested its worst impacts on domestic demand, exports, investments and unemployment, hence on growth. High inflation, escalating unemployment and weakened consumer confidence have resulted in a decline in private consumption despite government efforts to circumvent it by raising wages and employment. The rising labour cost has hit the real sector, especially on construction and manufacturing sectors. Exports have declined due to shrinking purchasing power of Western households. Import level sustained; but due to falling exports, trade balance made deficit. In sum, output dropped by 4.1% in the final quarter of 2008. The commission forecasts growth to contract by 3.4% in 2009, and to rise to 0.7% in 2010.[156] In line with slumping growth, budgetary deficit is expected to expand to 5.5% of GDP in 2009.[157] To sum, the two Eurozone members have circumvented the worst impacts of the crisis thanks to Eurozone cushioning but also due to domestic advantages, meaning better regulated sounder banking sector, low debt and deficit levels, an export-oriented economy and dynamic domestic consumption. Thus, the two countries fared well, despite economic slowdown; but the latter is a worldwide trait.

The crisis has caused recession in the Czech Republic. Its main impacts have revealed as the deterioration of labour market conditions, consumer expectations and

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[153] European Commission, *EU Employment Situation and Social Outlook*, April 2009, Commission official website, April 2009, http://ec.europa.eu/social/main.jsp?catId=120&langId=en, p.14.
[154] European Commission, "The Commission's economic forecast programme, SLOVAKIA", 04.05.2009, the official website, http://ec.europa.eu/economy_finance/pdf/2009/springforecasts/sk_en.pdf
[155] *EU Employment Situation and Social Outlook*, *op.cit.*, p.14.
[156] European Commission, "The Commission's economic forecast programme, SLOVENIA", 04.05.2009, the official website, http://ec.europa.eu/economy_finance/pdf/2009/springforecasts/si_en.pdf
[157] *ibid.*

tight credit conditions. Due to declining external demand, exports have made a negative contribution to output for the first time since the accession.[158] In addition, despite falling inflation, domestic demand has weakened due to rising unemployment and poor credit flow. Accordingly, growth has been deprived of its two main propellers; namely exports and domestic consumption. Growth has diminished to 3.2% in the 2008 and is expected to contract by 2.7% in 2009.[159] Industrial production has slumped, and particularly on manufacturing; layoffs have augmented thereof. Wages in the private sector have shrunk, while they somehow have sustained in the public sector. Such being the main indicators, the Commission estimates budgetary deficit to widen to 4.3% in 2009 and further to 4.9% in 2010; while it expects debts to rise to 38% of GDP in 2010.[160] However, as Table 3.2.1 shows, external debts are the lowest in the non-Euro area. Like Slovenia and Slovakia, the Czech Republic has hedged the adversities of the crisis thanks to its sounder banking sector. Czech banks have survived the financial turmoil, as the country was less dependent on foreign capital than some of its neighbours. This characteristic was the very reason why the government disjoined the 'Eastern Bloc', and refused to ask bailout for the non-Eurozone countries. The analysis of the Czech economic panorama tells more about the country's stance in the Union, particularly vis-à-vis the Eurozone. Because its economy fared better, the Czech Republic underlined at various occasions that the situation was not identical across the NMS. With a sounder banking system, relatively lower inflation level and good export and manufacturing performance, the Czech Republic had been preparing to join the Eurozone prior to the crisis. The crisis not only has hindered the process by rising debt levels, but also has caused exchange rate fluctuation therefore macroeconomic instability. In response to this impediment, the government asked alleviation of entry criteria to Eurozone so as to solve the problem of exchange rate instability. In other words, while the refusal of bailout request communicated the intent to prove superiority over other non-Eurozone members, the demand of the alleviation of the euro access criteria aimed to improve domestic economic conditions.

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[158] European Commission, "The Commission's economic forecast programme, THE CZECH REPUBLIC", 04.05.2009, the official website, http://ec.europa.eu/economy_finance/pdf/2009/spring forecasts/cz_en.pdf
[159] *ibid.*
[160] *ibid.*

Polish position in the EU was similar to Czech position at the beginning of the financial turmoil. Like in the Czech Republic, Slovakia and Slovenia, in Poland, banks also were stronger than in other NMS; therefore, the financial system has withstood the crisis. However, domestic banks occupied only a small portion in the sector. The financial sector was mainly dominated by foreign banks. As the latter have curtailed liquidity, funding opportunities have shrunk in the country. As a result of tightened access to credit, the crisis has hit Polish economy's two propellers of growth; that is, investments and private consumption. Nevertheless, it is worth reminding that according to Table 3.2.1, the decline in GDP is the smallest in Poland amongst non-Eurozone member states. Declining FDI and restricted access to credit have decreased investments. Only infrastructure investments have sustained thanks to EU funds and increasing government spending. Housing investments in particular, have faltered. Domestic demand has contracted due to rising unemployment, declining wages, deteriorating consumer confidence and limited access to credits. Decreasing demand in turn, has decelerated imports. Nevertheless, net exports have turned negative because of a shaper decline in exports than in imports. On the whole, budget made deficit by 0.3% in 2008.[161] Budgetary deficit is expected to widen in 2010 to more than 7% of the GDP, because of weakening growth and deteriorating labour market conditions. The situation on the real sector has in fact, worsened due to wage demands and increasing layoffs. Nevertheless, as Table 3.2.1 shows, the main challenge to the Polish economy has turned out to be the depreciation of the local currency. Even if the flexible exchange rate policy has cushioned local currency to some extent, it could not restore macroeconomic stability. Therefore, depreciation still is the major problem; it increases foreign debts of both households and the firms, discourages FDI, and triggers inflation.[162] In sum, due to the contraction of exports and credit growth, and slowdown in economic activity, the country has found recession at his doorway. To avoid recession, Poland received US$20.58 billion credit from the IMF in May 2009.[163] Consequently, even if Poland fared well at the beginning of the crisis, its performance has worsened because of external factors. The exchange rate fluctuation causes depreciation, while depreciation fuels inflation. The

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[161] European Commission, "The Commission's economic forecast programme, POLAND", 04.05.2009, the official website, http://ec.europa.eu/economy_finance/pdf/2009/springforecasts/pl_en.pdf

[162] *ibid*.

[163] IMF, "IMF Executive Board Approves US$20.58 Billion Arrangement for Poland Under the Flexible Credit Line", *Press Release,* No. 09/153, 06.05.2009, the official website, http://www.imf.org/external/np/sec/pr/2009/pr09153.htm

rising inflation distances Poland from joining the Eurozone. This panorama explains why Poland supported the Czech proposal of early facilitated entry to Eurozone, and not the Hungarian bailout proposal.

Once a well performing system, Hungarian economy first has lost the momentum of growth after the accession; then was devastated by the financial crisis thus becoming the first to fall in the EU. Growth dropped by 1.2% in 2008 immediately after the advent of the crisis, because the turmoil has arrested the three propellants of growth.[164] As regards the first one, foreign capital inflow has dried up as investors withdrew their money in favour of stronger currencies. Consequently, the local currency has devaluated, and the cost of foreign debts has significantly augmented. Table 3.2.1 approves this assertion; Hungary appears to be the member state displaying the biggest sum of external and public debts. In response to depreciation, Hungary stabilised the exchange rate regime so as to rectify the foreign exchange swap market.[165] As a result, "government bond yields have declined, foreign parent banks have continued to support their subsidiaries in Hungary, and international reserves have increased".[166] On the other hand, access to credit getting more difficult, liquidity shortage has aroused. Tightened credit flow, together with worsening expectations, has adversely affected private consumption, the second pillar of growth. In response to falling domestic demand, inflation and output have sluged, investments have slumped thereof. Investments have contracted in almost every sector; but the contraction was conspicuous particularly in manufacturing and construction. Only for infrastructure projects, investments have somehow sustained, and that thanks to EU funds. As a result, downturn has come about in all sectors; but the impacts were the hardest on manufacturing and the financial sector. As regards the third propellant, slowdown in world trade has caused diminution in both exports and imports. On the other hand, the decline in exports overweighing the decline in imports, net exports have made a negative contribution to budget. Besides, weakening export demand has induced further deceleration of output. Contracting output has

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[164] European Commission, "The Commission's economic forecast programme, HUNGARY", 04.05.2009, the official website, http://ec.europa.eu/economy_finance/pdf/2009/springforecasts/hu_en.pdf

[165] IMF, "Hungary—Stand-By Arrangement—Interim Review Under the Emergency Financing Mechanism", *IMF Country Report* No. 09/21, January 2009, the official website, http://www.imf.org/external/pubs/ft/scr/2009/cr0921.pdf.

[166] IMF, "The Hungarians made their own contribution", Dominique Strauss-Kahn, Interview with Népszabadság", 13.01.2009, the official website, http://www.imf.org/external/np/vc/2009/011309.htm.

translated as decreased employment. The combination of all these factors has put pressure on the budget. However, thanks to the fiscal consolidation programme entered into force in 2008, not only has budgetary deficit not widened, but also it has narrowed from 5% in 2007 to 3.4% of the GDP in 2008.[167] In sum, the crisis has caused sharp downturn in Hungarian economy. The impacts have turned out to be harder than elsewhere in the region, because Hungarian economy depended too much on foreign capital; its financial institutions were poorly regulated and less risk averse. Interlinks between the financial sector and the real economy have deepened the recession. As such, the country needed liquidity provision to prevent further deterioration. This urgency situation underlies the bailout demand from the IMF, the EU, and also the Hungarian PM's financial assistance request prior to the EU summit of March 1st.

On Baltic economies, the financial turmoil has also engendered recession. This outcome appears startling when thinking that the three countries had been recording better growth and inflation rates, as well as budgetary balance than other NMS. Yet, the crisis has devastated the Baltic states. How to explain this outcome? The reasons behind the downturn root in the structure of Baltic economies. To start with, the Baltic countries were using hard peg as exchange rate regime. This choice aimed to keep inflation low, to facilitate international financial integration and to ease the accession to Eurozone. The policy had proved successful, since the Baltics have attained greater growth rates than their neighbours before the crisis. However, it was not apt to withstand a challenge such as the 2008 crisis.[168] Baltic currencies were adversely affected by the strong euro, unlike the currencies under flexible exchange regime. As a result, their external debt levels peaked with the crisis. (See Table 3.2.1) Debt to GDP ratio changes from 2008, to 2009 and to 2010 were as follows: In Lithuania from 15.6% in 2008, to 22.6% in 2009, to 31.9% in 2010; in Latvia from 19.5% in 2008 to 34.1% in 2009, to 50% in 2010; and in Estonia from 4.8% in 2008, to 6.8% in 2009, to 7.8% in 2010.[169] Estonia seems to be better faring, while Latvia

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[167] "The Commission's economic forecast programme, HUNGARY", *op.cit.*
[168] Lutz, Mark, "Inflexible Budget Curbs Options as Estonia Faces Recession", *IMF Survey Magazine, Countries & Regions*, 15.04.2009, the official website, http://www.imf.org/external/pubs/ft/survey/so/2009/CAR041509A.htm.
[169] European Commission, "The Commission's economic forecast programme, LATVIA", 04.05.2009, the official website, http://ec.europa.eu/economy_finance/pdf/2009/springforecasts/lv_en.pdf; European Commission, "The Commission's economic forecast programme, LITHUANIA", 04.05.2009, the EU official website,

scores the worst. However, with regards to GDP growth, all the Baltics show more or less the same performance: In Latvia, GDP fell by 4.6% in 2008 and is expected to drop to 13% in 2009. In Estonia, GDP contracted by 9.7% in 2008 and is expected to reach 10% in 2009. Only in Lithuania, GDP grew by 3% after the crisis; however, it is expected to decline by 11% in 2009.[170] Although GDP drop is a region-wide pattern, the slump from 2008 to 2009 was sharper in Latvia and Lithuania.

Shrinking GDP resulted from plunging global demand and restricted credit flow. To remind, the propellers of Baltic growths were private consumption, investments, housing booms and credit flows. In line with the drop in credit flow, liquidity shortage has come about and investments have declined particularly in the housing and construction sectors. So, the housing boom, a specificity of Baltic economies, has come to an end. It is worth noting that investments have fallen also in manufacturing and transportation in Estonia.[171] Limited access to credit has adversely affected domestic demand. Private consumption has faltered, import did so too. In addition, sluggish external demand has restrained exports. As a result of the decrease across all types of demand, inflation has been facing downward pressure; but it still remains high due to external factors, such escalating energy and food prices, and also strong wages.[172] On the other hand, slowdown of economic activity reflected on the real sector as increasing unemployment. On the grounds of flexible labour market conditions, Baltic economies responded to unemployment with a cut in nominal wages. Lower wages, together with slumping demand, are likely to curb inflation in the medium term. On the whole, the crisis has arrested the miraculous Baltic growth. It has deflated the housing boom, and has curbed domestic demand. The reason behind the downturn was overheating prior to the crisis. Rapid credit growth and the housing boom have constituted the primary source of vulnerability, which the IMF report of 2008 had already warned about. Another weakness came from the fixed exchange rate regime. The latter has caused depreciation and instability. Finally, the deterioration of the international environment has adversely affected domestic

http://ec.europa.eu/economy_finance/pdf/2009/springforecasts/lt_en.pdf; European Commission, "The Commission's economic forecast programme, ESTONIA", 04.05.2009, the EU official website, http://ec.europa.eu/economy_finance/pdf/2009/springforecasts/ee_en.pdf.

[170] "The Commission's economic forecast programme, LATVIA", *op.cit.*; "The Commission's economic forecast programme, LITHUANIA", *op.cit.;* "The Commission's economic forecast programme, ESTONIA", *op.cit.*

[171] "The Commission's economic forecast programme, ESTONIA", *op.cit.*

[172] "The Commission's economic forecast programme, LATVIA", *op.cit.*; "The Commission's economic forecast programme, LITHUANIA", *op.cit.;* "The Commission's economic forecast programme, ESTONIA", *op.cit.*

demand in the Baltic region, one of the main propellers of growth. Such being the macroeconomic panorama, the countries gave support to both 'Eastern European' demands.

The downturn in Romania was no surprising; because the country, being one of the poorest EU members, constituted the weakest link. With the crisis, output and exports have contracted, while capital inflows have shrunk. In addition, the risk of capital outflow has come true. Accordingly, the banking system in Romania has been hit and liquidity shortage has aroused.[173] The recession has resulted mainly from two phenomena, the contraction in domestic demand and exports; the two motors of growth so to speak. To start with, tighter credit conditions have triggered exchange rate depreciation, thereby devaluation of the local currency (as indicated in Table 3.2.1). Depreciation has increased the cost of debts in foreign currency of both the households and firms.[174] Accordingly, domestic demand for consumption and investments have contracted by 2% after the crisis, versus their average increase of 14.5% in the first three quarters of 2008.[175] Depreciation also has widened budgetary deficits to 5.4% of GDP. The expansion resulted from lower tax revenues, and high government spending in the form of investments, public wages and social transfers. It is worth noting that by increasing public investments, government aimed to counter the reduction of credit flows.[176] Funding by the EU, the IMF and the World Bank also have helped counterpoise the decline in credits. So, the deficit is expected to linger around 5.2% in 2009 in relation to the government's austerity measures such as cuts on social spending, and on public sector wages. With regards to the second motor of growth, net exports maintained their positive contribution to GDP, because import demand has faltered more than external demand. Nevertheless, growth dropped to 7.1% in 2008 from 6.2% in 2007; and it is expected to remain so due to shrinking household consumption and government expenditure curtailed by fiscal measures.[177] Slugged output also has raised unemployment levels. This economic outlook

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[173] Berger, Roland, Pascu, Codruj, and Leaua, Iona, "Romanian banking system", *IBP*, Romanian Business Digest, http://rbd.doingbusiness.ro/en/2009/april/overview-of-economic-sectors/1/136-romanian-banking-market-overview.html.

[174] IMF, "Romania Receives Support from IMF to Counter Crisis", *IMF Survey Magazine*, Interview, 04.05.2009, the official website, http://www.imf.org/external/pubs/ft/survey/so/2009/int050409a.htm.

[175] European Commission, "The Commission's economic forecast programme, ROMANIA", 04.05.2009, the official website, http://ec.europa.eu/economy_finance/pdf/2009/springforecasts/ro_en.pdf.

[176] "The Commission's economic forecast programme, ROMANIA", *op.cit.*

[177] *ibid.*

explicates why Romania asked bailout from the EU and the IMF, as well as why it sided with the countries that formulated the financial assistance demand.

In Bulgaria, another poor member of the Union, the impacts of the crisis have happened to be harder than expected. This was mainly because of external factors; the contraction in global demand and trade flows, as well as confidence erosion on the private sector due to worsening global financial situation and crashes in stock markets.[178] The deterioration of the international environment has put pressure on real GDP. In that, slumping external demand has limited exports, one of the two propellers of growth. On the other hand, domestic demand did not decelerate at the same rate as external demand; therefore, imports have somewhat sustained. Accordingly, net exports have made a negative contribution to GDP.[179] Furthermore, as capital flows have slugged, as a result of risk aversion at the global level, investments have declined sharply and are expected to remain so in 2010.[180] In line with falling domestic demand, capital flows and investments, unemployment is expected to rise. Weaker labour demand is likely to curb nominal wages that were set high prior to the crisis. Finally, due to the fixed exchange rate regime, the local currency has depreciated; the cost of debts in foreign currency of households and firms has risen, which has added to the factors decreasing domestic demand. The drop in all types of demand has refrained inflation. So, as a result of economic slowdown, GDP has contracted for the first time since 1997; and is expected to slow down by 0.5% in 2009.[181] The IMF however, forecasts the contraction to be around 3.5% in 2009.[182] In addition, budgetary balance, which used to give surplus, made deficit by 0.5% in 2009. Given economic slowdown and budgetary instability, public debts are expected to rise above 17% of GDP in 2010.[183] On the other hand, Bulgarian economy has fared well on the financial sector. The crisis has not unsettled the banking system, because Bulgarian banks managed to issue liquidity using their profits from 2008. To remind, in other countries, including the Eurozone members,

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[178] IMF, "Bulgaria—April 2009 Staff Visit: Concluding Statement of IMF Mission", 22.04.2009, the official website, http://www.imf.org/external/np/ms/2009/042209.htm.
[179] European Commission, "The Commission's economic forecast programme, BULGARIA", 04.05.2009, the official website, http://ec.europa.eu/economy_finance/pdf/2009/springforecasts/bg_en.pdf.
[180] *ibid.*
[181] *ibid.*
[182] "Bulgaria—April 2009 Staff Visit: Concluding Statement of IMF Mission", *op.cit.*
[183] "The Commission's economic forecast programme, BULGARIA", *op.cit.*

governments had undertaken bank capitalisation.[184] In sum, even if Bulgaria has circumvented the liquidity problem owing to its sounder banking sector, the country has been witnessing slowdown of economic activity, and external and internal imbalances thereof. The ongoing recession is likely to persist in the immediate future. So, Bulgaria has not arisen as a leading figure in the advocacy of the two 'Eastern European' demands; because it was relatively a younger and weaker member. It yet provided support because of the recession at home.

So far, the section has scrutinised the worldwide, EU-wide and region-wide impacts of the crisis. The analysis has established that decline in growth and trade, depreciation and fall in stock markets were the region-wide implications. Even if all NMS received these impacts, damages have occurred at different levels. The gravity of the implications depended on domestic factors, and particularly on those underlying growth. Table 3.2.2 summarises the NMS specific implications across economic areas.

Table 3.2.2

Country	The Most Damaged Economic Areas by NMS							
	Private Consumption	Investments	Credit Flow/FDI	Exports	Financial Institutions	High Inflation	Unemployment	Exchange Rate Depreciation
Baltic States	X	X	X		X	X	X	X
Slovenia	X	X		X		X	X	
Slovakia	X	X		X		X	X	
Czech Republic	X		X	X			X	X
Poland	X	X	X	X			X	X
Hungary	X	X	X	X	X		X	X
Bulgaria	X	X	X	X			X	X
Romania	X	X	X	X	X	X	X	X

The countries that were the worst hit were the ones with a weak financial system. The weakness stemmed from "badly run local banks with loosely overseen subsidiaries of Western ones".[185] Even if poor regulation and risk taking helped attract a considerable amount of foreign capital, thereby foster growth prior to the crisis, they have proved to be fatal once foreign investors withdrew their money. Hungary and Romania fall into this category. In contrast the countries with a sounder banking system, namely the Czech Republic, the Baltic states, Bulgaria, Poland, Slovenia and Slovakia, have circumvented this risk. A comparison of Bulgaria to

[184] "Bulgaria—April 2009 Staff Visit: Concluding Statement of IMF Mission", *op.cit.*
[185] "Argentina on the Danube?", *The Economist*, 19.02.2009, http://www.economist.com/opinion/displaystory.cfm?story_id=13144925

Romania is particularly illustrating at this point. Both countries displayed similar characteristics, such as a small size economy with poor income per capita, dependence on credit flow etc. However, because its banking system was better regulated and more risk averse, financial difficulties were not the reason behind the downturn in Bulgaria. Bulgaria has undergone recession, because plunging external demand has incised its exports, and impoverished credit flows has curbed domestic demand. In effect, in line the IMF thesis; the vulnerability for Bulgaria was its being a small size economy depending too much on exports. Secondly, the economies using fixed exchange rate regime have had problems with trade, domestic demand and inflation, because of the strong position of euro. The Baltic states and Bulgaria embody this strand. Exchange rate regime has been particularly fatal for the Baltics; their debt levels have rocketed. Thirdly, the countries where credit flow created housing booms have experienced high debt levels and decline in domestic demand. Again, the Baltic states and Bulgaria exemplify the trait. In sum, the countries displaying one or more of these vulnerabilities have been the worst damaged by the crisis; namely, the Baltic members, Hungary, Bulgaria and Romania. In contrast, the countries applying stable macroeconomic policies before the crisis have performed better. Slovakia, Slovenia, the Czech Republic, and Poland to some extent, appear in this category. Notwithstanding the decline in exports and in output and high inflation, the countries exhibit some crucial strengths; sounder financial institutions, flexible exchange regime, and growth propelled by domestic demand. In addition to these strengths, the Czech Republic and Poland have enjoyed the advantage of being larger size economies. In that, even if their growth depended also on exports, the Czech Republic and Poland hedged collapse unlike Bulgaria. On the other hand, Slovenia and Slovakia were small size economies; but they profited from the comparative advantages is of Eurozone membership vis-à-vis the other NMS.

Of this lengthy analysis, this chapter draws three conclusions. Firstly, despite region-wide macroeconomic trends, the NMS performances were different before and after the accession. They all displayed domestic vulnerabilities, but of dissimilar kind. As a result, not all NMS were devastated by the crisis. That means, the German argument as to which the situation was not the same for all Central and Eastern European states was accurate. It further means that the decision to bail out on a case-

by-case basis fell in line with the macroeconomic realities in the region. Secondly, the type and the gravity of domestic problems at home have determined the stance of a member state in the Union. Those suffering from exchange regime problems supported early facilitated entry demand, those with high debts and liquidity shortage asked bailouts. Thirdly, because the impacts of the crisis have been worse in some NMS, those who performed better, namely Poland and the Czech Republic, attempted to distinguish themselves from the weaker ones. It thus has become clear that an 'Eastern Bloc' does not exist. The NMS race with each other to promote to the level of the old members. Only, the domination of the interests of the old members gives the incentive to form an 'Eastern coalition' in an attempt to counterpoise the West-inclined balance of power. Nevertheless, this chapter has affirmed that, on the whole, the macroeconomic impacts of the crisis have been harder in Central and Eastern Europe than in the Eurozone. On the other hand, the crisis has produced also social and political problems, which, since the beginning of 2009, have been escalating on the agendas of the EU and other international instances such as G20, the IMF or WB. Given the importance of this aspect, this thesis proceeds to an analysis of the social and political implications of the crisis in the region.

Chapter IV

THE SOCIAL IMPACTS OF THE CRISIS ON CENTRAL AND EASTERN EUROPEAN COUNTRIES

This chapter examines the non-economic impacts of the crisis on Central and Eastern Europe. The term 'non-economic' designates social, political and ethnic costs of the crisis. The chapter is sectioned in two parts. The first part dwells upon the social and political implications of the crisis. The objective is to reveal the way in which social dissatisfaction with the situation in the country was channelled, and whether, and if so, how the polity responded to the various expressions of social discontent. The analysis covers the period from the outbreak of the crisis to April 2009. The data is collected mostly from media; therefore, the research materials encompass dossiers, newspaper articles and so forth.

IV. I. Socio-political Costs of the Crisis

This part elaborates on social and political costs of the crisis. To start with, the financial collapse has instigated social and political instability everywhere across the EU; protests and rallies have been channelling discontent in both Western and Eastern Europe since the beginning of 2009. The objective is to identify the patterns of social and political costs, and whether, if ever, they concentrate in particular areas in the region. To this end, this section undertakes a country-specific analysis covering the period from January 2009 to April 2009. It is hypothesised that social costs have been the highest in the countries where the macroeconomic impacts have been the hardest.

After the IMF bailout, the Latvian government has cut down on budget to restore the economy. The government decreased wages of civil servants by 1/3; increased VAT to 21%, and closed down some schools and hospitals. These measures have created intense discontent and have eroded trust in the government. On January 13, "thousands of people protested in Riga, Latvia, demanding snap elections and the

resignation of the government in the face of a deepening economic crisis".[186] Demonstrators protested the up to $3 billion burden imposed on taxpayers as a result of the collapse and nationalisation of the biggest Latvian bank, Parex. The riot also was a reaction to the Parliament's decision on budgetary cuts which would shrink state employees' wages by up to 15%.[187] In the street battles, more than 40 people got hurt, and 106 people were arrested. The Latvian President explained the uprising by declining trust in state authority as a result of the public perception that the chain of events starting with the IMF bailout has caused 'national humiliation'. On January 21, more than 200 farmers gathered in Valmiera to protest the crisis in farming business. "Farmers demanded monthly loans that were being on hold for one year, and a temporary ban on the banks' right to increase interest rates on loans to farmers."[188] Protests continued in February. On February 3, farmers gathered to demand the resignation of the minister, and higher prices for milk.[189] The continuous protests compelled the Latvian PM to resign on February 20. Hence, the Latvian government became the second to resign because of the implications of the crisis.[190] On April 2, "over 10 000 teachers blocked the streets of Riga to protest against government plans to cut funds for education and decrease public-sector wages by up to 40%".[191] The demonstration, led by Latvian Education and Science Workers Association, gathered teachers from all over the country.

In Lithuania, discontent has aroused as a result of the government decision to cut expenditure in the public sector, on social security and on subsidies for medicine and heating, and to raise taxes. On January 16, three national trade unions launched a "general protest action in front of the parliament and government buildings under the slogan 'Stop impoverishment and unemployment, stop disruption of business, stop

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[186] "Anti-government demo in crisis-hit Latvia draws crowds", *AFP*, 13.01.2009, http://www.google.com/hostednews/afp/article/ALeqM5hb7uBlXP_ckSCGBYjgBq5Whg4wMg

[187] *ibid.*

[188] Kolyako, Nina, "Latvian Farmers Protested in Valmiera", *the Baltic Course*, 21.01.2009, http://www.baltic-course.com/eng/markets_and_companies/?doc=8954

[189] Mardell, Mark, "Protests Rock Latvia", *BBC News*, Euroblog, 03.02.2009, http://www.bbc.co.uk/blogs/thereporters/markmardell/2009/02/riga_latvia_since_dawn_the.html

[190] "Global Financial Crisis Forces Latvia's Government To Resign", *Pak Alert Press*, 23.02.2009, http://pakalert.wordpress.com/2009/02/23/global-financial-crisis-forces-latvia%E2%80%99s-government-to-resign/

[191] "Latvian teachers stage huge pay protest", *Morning Star*, 02.04.2009, http://www.morningstaronline.co.uk/index.php/news/world/latvian_teachers_stage_huge_pay_protest

the extermination of sports, press and culture".[192] The unions' actions turned into a riot. Some demonstrators threw stones to parliament; police expelled them by using teargas.[193] The protesters demanded that social and economic policies target the most disadvantaged groups during the recession period. The trade unions on the other hand, dissociated themselves from the rioters and submitted a list of requirements to the government. On April 4, police officers, firefighters and border guards made a protest march for better pay and against cuts in social spending in the capital city.[194]

Violent demonstrations also took place in Bulgaria. In January, student organisations, environmentalists and trade organisations organised a three days rally where they voiced in total 19 demands, such as better education, fight against corruption and mafia, better agricultural policies etc. On January 14, around 2000 people protested against the government. Violent clashes occurred as protestors threw stones. Around 17 protestors and six police officers were injured. Police arrested more than 50 protestors. Demonstrations continued on January 15 and 16; yet without violence and less participation.[195] In February, police officers vowed to protest until the government improved their wages and working conditions. On February 4, farmers made a huge demonstration to protest against low milk prices. The protestors also opposed the government's import of cheap milk from other EU member states.[196] Around 100 farmers blocked a key border crossing point to Romania. For March, leaders of the student protests had already scheduled in December a demonstration to take place after the adjournment of parliamentary sessions.[197] About 2000 people protested the government in Sofia. The group encompassed students who accused the government for failing to ensure security, and farmers who objected to corruption and low prices for their produce. The gas crisis with Russia and Ukraine constituted another factor that fuelled discontent with government. Protesters distanced

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[192] "Trade unions organise national protest to demand action on economic crisis", *eironline*, European Industrial Relations Observatory Online, 02.03.2009, http://www.eurofound.europa.eu/eiro/2009/01/articles/lt0901019i.htm

[193] Adomaitis, Nerijus, "Lithuanian PM defiant after protest turns violent", Reuters, Canada.com, 16.01.2009, http://www2.canada.com/news/iceland+police+cool+protests+with+pepper+spray/1198270/story.html?id=1185359

[194] Joshi, Mohit, "Latvian teachers, Lithuanian police protest pay cuts", *Top News*, 04.02.2009, http://www.topnews.in/latvian-teachers-lithuanian-police-protest-pay-cuts-2146588

[195] Guineva, Svetlana, "Chronicle of a Protest Foretold", Sofia Echo, 16.01.2009, http://sofiaecho.com/2009/01/16/666114_chronicle-of-a-protest-foretold

[196] "Bulgarian Farmers in EU milk protests", EU Business, 04.02.2009, http://www.eubusiness.com/news-eu/1233753428.28/

[197] Ciobanu, Claudia, "BULGARIA: Protests Rise Above Parties, and Against Them", IPS, 26.01.2009, http://ipsnews.net/news.asp?idnews=45540

themselves from any partisan allegiance. On March 15, thousands of police officers marched in Sofia to demand a 50% wage rise and better working conditions.[198] A wave of strikes by Bulgarian steel mill workers took place throughout March and April. The latest wave on April 29, gathered about 1000 workers who protested over unpaid salaries and demanded help from the government for their ailing plant. The rally voiced dissatisfaction with the government's failure to raise living standards, corruption and mismanagement of the crisis.[199] Trade unions in fact, had been calling on Economy Minister to resign. Teachers and doctors also announced that they would join the steel mill workers' protests.[200]

In Romania, various protests took place against job insecurity and government policies. On January 13, thousands of workers from car industry companies linked to the Dacia-Renault, made demonstrations to support the government tax for importing second-hand cars to Romania. Workers also protested the continual production break that the company had decided one month ago, and demanded job guarantee.[201] The company management had declared in January that they were considering reduction of the workforce by a ¼ due to the slumping demand. On the public sector side, the situation was not brilliant either. On 9 February, some 500 members of researchers' trade unions organised a protest march against the governments' reduction of the R&D budget.[202] On April 29, about 6000 employees from state-run railway company, CFR, protested government plans to cut down up to 12 000 jobs. The Transport Ministry denied the claim of layoff, and averred they instead planned to decrease salaries.[203] The government then announced wage freeze in public sector on April 28, to which the main teachers' union replied by a strike announce.

In Poland, the All-Poland Trade Union of Physicians launched a protest action on 5 January 2009 against the government plan to reduce financing for medical

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[198] "FACTBOX-Financial crisis sparks unrest in Europe", Alibaba.com, 22.03.2009, http://news.alibaba.com/article/detail/markets/100072729-1-factbox-financial-crisis-sparks-unrest-europe.html

[199] "Bulgarian steel workers rally over delayed pay", *Reuters*, 01.04.2009, http://in.reuters.com/article/rbssIndustryMaterialsUtilitiesNews/idINL121865620090401

[200] "Bulgarian Steel Workers Rally Grows into National Protests", *Sofia News Agency*, 10.04.2009, http://www.novinite.com/view_news.php?id=102674

[201] "Dacia, Renault face economic and worker strife", *New Europe*, the New European Weekly, 19.01.2009, http://www.neurope.eu/articles/92130.php

[202] "R & D trade unions protest to halt funding cuts", *EIRONLINE*, European Industrial Relations Observatory Online, http://www.eurofound.europa.eu/eiro/2009/02/articles/ro0902029i.htm

[203] "Protests of Romanian Railway Workers", BalkanInsight.com, 29.04.2009, http://balkaninsight.com/en/main/news/18522/

services provided in hospitals. "Trade union activists put up posters in about 80 hospitals in which the trade union is represented, proclaiming 'I pay 10% more for health and receive 10% less. Give me my money back'."[204] The protests continued throughout January. The deterioration of economic situation intensified social discontent in March. On March 6, up to 10 000 workers, mainly from the arms industry, protested against looming layoffs after the government cut down on defence budget.[205] Discontent also gained miners. About 65 000 coal miners from the state run and operated Kompania Weglowa, Europe's largest coal producer, went on strike, in mid March, to protest low wages. On March 26, about 1000 workers including coal miners and shipyard workers marched through Warsaw. Protestors burned tyres and threw firecrackers to protest the government's economic policy, layoffs in public sector in particular. The protesters exclaimed they did not want to pay for the crisis.[206] On April 29, shipyard trade unions protested EU-mandated closures in the Polish shipbuilding sector in Warsaw. Violent clashes took place between demonstrators and police; several people were injured; and police used tear gas and rubber batons against demonstrators throwing firecrackers and burning wheels.[207] The unions also channelled their dissatisfaction with the government's too liberal policies. Another branch of the group made demonstrations in Brussels in front of the European Commission to protest the latter's decision to rule out Polish state aid to shipyards, on the grounds that it had breached competition rules, and had produced a major restructuring that would cost thousands of job losses.[208]

In Hungary, the farming subsidies issue was troublesome. On February 16, farmers launched a 10-day protest by blocking the country's major roads to demand greater subsidies, and measures against imported products sold at below-market prices. Upon the government's approval, farmers ended their protest on February

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[204] "Doctors protest against reduced financing of hospital services", *EIRONLINE*, European Industrial Relations Observatory Online, http://www.eurofound.europa.eu/eiro/2009/01/articles/pl0901049i.htm
[205] "POLAND: Up to 10,000 demonstrators gather in Warsaw to protest government budget cuts and industry job losses", *ITN Source*, 07.03.2009, http://www.itnsource.com/ shotlist//RTV/2009/03/07/RTV398209/
[206] "Polish Workers Stage Protest Rally In Warsaw", *Javno*, 26.03.2009, http://www.javno.com/en-world/polish-workers-stage-protest-rally-in-warsaw_246218
[207] Pop, Valentina, "Violent clashes mar centre-right congress in Poland", *EU Observer*, 29.04.2009, http://euobserver.com/9/28038
[208] "Walesa Appeals To EU To Save Polish Shipyards", *Javno*, 30.04.2009, http://www.javno.com/en-world/walesa-appeals-to-eu-to-save-polish-shipyards_254806

25.[209] Several thousand people made an anti-government protest on March 15. The demonstration took upon a violent tone when some protestors tried to attack police lines; police used tear gas to strike them back. 35 people were detained.[210] On March 21, the socialist government resigned amid battles over spending cuts. The Socialist leader, in power since 2004, recognised the decline of his popularity due to tax hikes and spending cut; and expressed that he considered himself a hindrance to further economic and social reforms.[211] The new PM, who was Mr Bajnai, a non-aligned figure who had been serving as the economy minister, was invested in mid April. Following the investiture, several thousand people made protestations against the new PM's plan to implement tough austerity measures in Budapest. A group of protesters on motorbikes drove into a police cordon and police used teargas.[212] On April 27, the Liga trade union confederation called for a nationwide strike on May 8 to protest against the economic programme of the new PM. The PM however, affirmed that he saw no "chance to change his crisis management programme".[213] On 30 April, Free Union of Railway Workers (VDSZSZ), representing about a ¼ of all railway employees, announced an 18 hour strike. Union finds the governments' plans unacceptable.[214]

Economic situation was more brilliant in the Czech Republic; yet the country did not go unaffected by the wave of discontent. On March 2, around 500 workers from the troubled glass giant Bohemia Crystalex Trading protested against the government's lack of action towards the company's bankruptcy and unpaid salaries. Wages were unpaid since September 2008, as many factories bankrupted due to the slumping demand for exports.[215] The protesters demanded extraordinary social benefits from the government.[216] In addition, on March 12, over 8000 farmers

[209] "Hungarian farmers end protest as government promises more subsidies", *EU Business*, 26.02.2009, http://www.eubusiness.com/Hungary/040226091635.bf228go6/
[210] Gorondi, Pablo, "Anti-government protests in Hungary", *Washington Times*, 15.03.2009, http://www.washingtontimes.com/news/2009/mar/15/anti-government-protests-in-hungary/
[211] "'Obstacle' Hungary PM to resign", *BBC NEWS*, 21.03.2009, http://news.bbc.co.uk/2/hi/europe/7956610.stm
[212] "Protests as Hungary PM sworn in", *BBC NEWS*, 14.05.2009, http://news.bbc.co.uk/2/hi/europe/7999289.stm
[213] "Liga trade unions call for general strike on May 8", *The Budapest Times,* 25.04.2009, http://www.budapesttimes.hu/content/view/11768/159/
[214] "Hungary, train strike", *Easy Travel Report*, 30.05.2009, http://www.easytravelreport.com/countrys/country-hungary-train.html
[215] "CZECH REPUBLIC: Glass and china makers demonstrate as wages go unpaid", *ITN Source*, 03.03.2009, http://www.itnsource.com/shotlist//RTV/2009/03/03/RTV372409/
[216] "Hundreds glass workers rally in Prague", *Radio Praha*, 02.03.2009, http://www.radio.cz/en/news/113791

gathered to protest against low prices, and the EU's distribution of subsidies.[217] Farmers from Slovakia, Hungary, Lithuania and Slovakia also participated in the rally.[218] Dairy farmers again made a demonstration on April 29, for fair milk prices and better conditions. To the rally, some 25 000 dairy farmers coming from all over Europe took part.[219] On April 29, Czech truckers rallied to protest against the outgoing PM's failure to introduce toll rebates. The government replied by pointing at high oil prices and the strong euro.[220] The Czech Republic did not undergo violent uprising; nevertheless discontent was intense enough to result in cabinet change. On March 24, the government collapsed after losing a vote of no-confidence tabled by the opposition Social Democrats.[221] The Social Democrats were criticising the government's economic decision in the face of the crisis. Hence, the Czech government became the third cabinet to collapse in Central and Eastern Europe after the crisis.

As regards the Eurozone members, none of them were unsettled by social unrest, except violent demonstrations in Greece. In Slovakia, no protest or demonstration took place. In Slovenia, no uprising occurred but the government's measures to face the crisis caused controversy with trade unions and public servants, none of them were yet violent. In the face of the crisis, the government raised debt to €2.8 billion in 2009.[222] It introduced a temporary reduction of salaries in the public sector.[223] It yet, showed solidarity with people by decreasing salaries of ministers and state secretaries.[224] The pay cut issue instigated judges to go on strike to protest against the government's pay offer in March.[225] In January, Slovenia's biggest union confederation, ZSSS, made a peaceful protest in front of the parliament against the

[217] Johnston, Rosie, "Farmers protest about EU agriculture subsidies in Prague", *Radio Praha*, 13.03.2009, http://www.radio.cz/en/article/114188

[218] "EU farmers protest in Prague", *Prague Daily Monitor*, 13.03.2009, http://praguemonitor.com/2009/03/13/farmers-several-european-countries-protest-prague

[219] "Dairy farmers in Czech Republic protest low milk prices", *Radio Praha*, 29.04.2009, http://www.radio.cz/en/news/115805

[220] "Truckers protest in Litoměřice", *Radio Praha*, 29.04.2009, http://www.radio.cz/en/news/115805

[221] "Czech government toppled in no-confidence vote", *Radio Praha*, 24.03.2009, http://www.radio.cz/en/news/114529

[222] "Govt Debt to Rise by 30% in 2009", *STA*, Slovenska tiskovna agencija / Slovenian Press Agency, 04.01.2009, http://www.sta.si/en/vest.php?s=a&id=1351225

[223] "Govt Drafts Bill Cutting Salaries for Public Servants by 4%", *STA*, Slovenska tiskovna agencija / Slovenian Press Agency, 12.02.2009, http://www.sta.si/en/vest.php?s=a&id=1363400

[224] "Govt Pay Cut a Signal to Others, PM Tells Vecer", *STA*, Slovenska tiskovna agencija / Slovenian Press Agency, 03.01.2009, http://www.sta.si/en/vest.php?s=a&id=1351207

[225] "Judges Still Refuse to End Strike", *STA*, Slovenska tiskovna agencija / Slovenian Press Agency, 12.03.2009, http://www.sta.si/en/vest.php?s=a&id=1372131

government bill on subsidies to companies introducing a shortened working week due to crisis.[226] The unions demanded subsidies to extend. ZSSS extended its demands over welfare issues in the following months. On January 28, ZSSS issued a proposal on changes to the employment and insurance against unemployment acts, and to the social security act.[227] In February, it opposed the government's cutting sickness benefit rights.[228] In April, the union confederation made a demonstration to protest against the government's policy regarding pensions.[229] On the private sector side, about 250 workers of the rail vehicle assembly plant STS, linked to German group Siemens, protested against the company's plans to close the plant down on January 29.[230]

In sum, the deterioration of the socioeconomic conditions after the crisis has engendered social discontent across Europe. People made demonstrations and/or went on strike to protest against job insecurity and dwindling welfare benefits. However, social discontent took the form of social unrest in the countries where the macroeconomic impacts have been the hardest. In effect, violent protests and rallies took place in Hungary, Latvia, Romania, Bulgaria and Lithuania. The governments of Hungary and Latvia had to resign in the face of intense social discontent. On the other hand, Poland and the Czech Republic, which have better survived the crisis, also witnessed protests and demonstrations. These actions however, were not of a violent nature. Nevertheless, the population was discontent of worsening conditions and tough economic measures. The measures cost the governments their popularity. The escalating discontent in the Czech Republic urged the PM to resign. As such, the Czech Republic became the first country holding presidency whose leadership lacked support. The Eurozone countries did not exhibit any violent uprising. Economic measures created tensions between government and trade unions, which is a trait of democracy. The costs of the crisis did not yet limit to socioeconomic features. In

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[226] "Unions Protest Against Companies Subsidising Bill", *STA*, Slovenska tiskovna agencija / Slovenian Press Agency, 14.01.2009, http://www.sta.si/en/vest.php?s=a&id=1354270
[227] "Trade Unions want higher welfare benefits", *STA*, Slovenska tiskovna agencija / Slovenian Press Agency, 28.01.2009, http://www.sta.si/en/vest.php?s=a&id=1358694
[228] "Trade Unions Against Cutting Sick Leave Rights", *STA*, Slovenska tiskovna agencija / Slovenian Press Agency, 04.02.2009, http://www.sta.si/en/vest.php?s=a&id=1360798
[229] "Trade Unions to Stage Protest over Pensions Age Limit", *STA*, Slovenska tiskovna agencija / Slovenian Press Agency, 01.04.2009, http://www.sta.si/en/vest.php?s=a&id=1378294
[230] "Maribor STS Workers Stage Protest in Ljubljana", *STA*, Slovenska tiskovna agencija / Slovenian Press Agency, 29.01.2009, http://www.sta.si/en/vest.php?s=a&id=1359038

some new member states, ethnic violence has intensified in the aftermath of the crisis, which will be the subject of the next section.

IV. II. Ethnic Costs of the Crisis in Hungary and the Czech Republic

This section deepens the analysis of human cost to the ethnic level. The objective is to identify the mechanisms whereby economic adversities have transformed into ethnic violence, and whether this type of cost displays a geographic pattern.

In the aftermath of the crisis, social unrest has manifested itself, also, through violence against ethnic minorities in the Czech Republic and Hungary. The Roma community became a conspicuous target. Notwithstanding that anti-Roma feeling is manifold, which economics constitutes but one aspect, many argue that the crisis has rekindled the anti-Roma feeling.[231] To start with, the Roma constitute a group whose situation were one of the most deteriorated amongst the society, as they fall within the poorest segments of the society across Europe. World Bank report of 2003 defines the Roma as "the most prominent poverty group in many of the countries of Central and Eastern Europe. Roma are both poorer than other groups, and are more likely to fall into poverty and remain poor. (…) poverty rates are particularly high in Bulgaria, Hungary and Romania."[232] World Bank Report of 2006 reaffirms the finding; the Roma were "one of the largest and poorest and fastest growing minorities in Europe."[233]

Secondly, "poverty among Roma is multidimensional, related to low education levels, poor health status, high unemployment, inadequate housing, and compounded

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[231] Legendre, Paul, director of the fighting discrimination program at Human Rights First, in "Roma are scapegoats during downturn", *Human Rights Tribunal*, 09.04.2009, http://www.humanrights-geneva.info/Roma-are-scapegoats-during,4328; Vesely, Ivan, chairman of the Dzeno Association, a Prague-based non- governmental group dealing with Roma issues, statement to *Inter Pres Institute*, in Dujisin, Zoltán, "Rights: Roma Seek to Flee Czech Republic", *Global Issues*, 30.04.2009, http://www.globalissues.org/news/2009/04/30/1360

[232] World Bank Institute, "World Bank Involvement in Roma Issues", the official website, 2003, http://www.worldbank.org/eca/roma/data/briefing.pdf, p.1.

[233] World Bank Institute, "Development Outreach", the official website, February 2006, 37250, http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2006/09/14/000090341_20060914094747/Rendered/PDF/37250.pdf, p.30.

by widespread exclusion and discrimination within society."[234] The 2006 report adds that "living conditions of Roma have deteriorated disproportionately compared to other groups. They were affected by restructuring following the economic transition in the 1990s".[235] Poverty among Roma has increased due to the closure or privatization of the large state companies. Since most of them are poorly educated and unskilled workers, their employment opportunities are scarce. As a result, most Roma depend on welfare benefits. However, welfare services towards this group have been underperforming in Eastern Europe. In the Czech Republic and Slovakia, Romani children face segregation in schools; they are sent to schools for children with mental disabilities, "despite a ruling by the European Court of Human Rights in November 2007 that it amounted to unlawful discrimination".[236] As such children receive poor education, hence having access to limited job opportunities. In Romania, the Roma suffer from poor housing. They live in barracks exposed to adverse weather conditions and poor health conditions.

In Bulgaria, the Roma are deprived of medical and social assistance. The European Committee of Social Rights condemned Bulgaria for violation of the European Social Charter on April 5, 2009, with regards to these issues.[237]

Thirdly, the Roma face discrimination in almost every aspect of social life. The EU Minorities and Discrimination Survey of 2008 qualifies the Roma as the group with "the highest overall levels of being discriminated against of all groups surveyed for EUMIDIS."[238] According to EU report, the Roma face discrimination in looking for work; at work; in looking for a house or an apartment to rent or buy; by healthcare personnel; by social service personnel; by school personnel; at a café, restaurant, bar or club; when entering or in a shop; and when trying to open a bank account or get a loan. In line with these findings, World Bank Report of 2006 notes that the Roma "are often the first to be laid off from jobs, and have been persistently blocked from re-entering the labour force due to low skill and education levels, and

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[234] "World Bank Involvement in Roma Issues", *op.cit.*, pp.1-2.
[235] "Development Outreach", *op.cit.*, p.30.
[236] Amnesty International, "Roma protest demands Czech Republic stops growing extremism", 01.05.2009, http://www.amnesty.org/en/news-and-updates/news/roma-protest-demands-czech-republic-stops-growing-extremism-20090105
[237] European Roma Rights Center, "European Committee Rules Bulgaria is Violating the Right to Health Care for Roma People", the official website, 05.05.2009, http://www.errc.org/cikk.php?cikk=3028
[238] EU Agency for Fundamental Rights, "EU Minorities and Discrimination Survey", Data in Focus Report, the EU official website, 2009, http://fra.europa.eu/fraWebsite/attachments/EU-MIDIS_GLANCE_EN.pdf, p.2.

discrimination."[239] Before the crisis, Roma immigrants had been providing cheap labour in the market, thereby had been contributing to housing booms.[240] As mortgages have crashed after the crisis and industries have set about laying off, most Roma lost their jobs.

On the other hand, the Roma experience criminal victimisation, including racially motivated crime, in five different areas; namely, theft of or from a vehicle; burglary or attempted burglary; theft of personal property not involving force or threat; assault and threat; serious harassment. In addition, the survey identifies that discrimination and ethnic violence are more widespread than recorded in official statistics. The level of discrimination is the highest in the Czech Republic (64%); and the lowest in Bulgaria (26%) and Romania (25%). Hungary scores (62%) in the survey.[241]

To fight poverty and unemployment thereby to enable social integration of the Roma, social policies to build skills and to improve education have proved crucial. However, governments, in the aftermath of the crisis, were busy channelling resources to stimulate businesses and the financial sector; hence the already restricted level of social spending (such as education, aids to large families and to the long term unemployed and programmes designed to fight social inclusion) in national budgets has further dwindled. The Czech Republic is a conspicuous example; funds for teaching assistance programmes to Roma children have dropped to a large extent.

Right after the outbreak of the financial crisis, attacks against the Roma resurged in Eastern Europe. In the Czech Republic, on 17 November, 500 black-masked people voicing racist slogans tried to attack a Roma ghetto in Litvinov, a town in the north of the country characterised by high unemployment rate, 12%- which equates to double the national average.[242] On November 21, extreme right protesters, backed by the nationalist Czech Workers Party and members of the town's dominant white community, had street battles with police. 14 people were injured. On

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239 "Development Outreach", *op.cit.*, p.30.

240 Mark, David, "The picture is grim for Europe's Roma", *EU Observer*, 09.12.2008, http://euobserver.com/851/27250

241 "EU Minorities and Discrimination Survey", *op.cit.*, p.8.

242 Winfrey, Michael, "ANALYSIS-Racist violence flares in Central and Eastern Europe", *Reuters Alter Net*, 21.11.2008, http://www.alertnet.org/thenews/newsdesk/LJ27455.htm

April 4, around 500 extreme right supporters organized a march through the Roma-populated area in Přerov. Participants to the rally shouted slogans against "gypsy terrorism", and defined the Roma as "parasitic".[243] The demonstrators attacked police with stones, petrol bombs, and firecrackers. The violence spread into the surrounding streets. The police could secure the Roma-populated neighbourhood with tanks, police vans and riot police. On April 18, molotov cocktails were thrown on domiciles in the village of Vítkov.[244] Czech PM Topolanek explained ethnic violence through the financial crisis. "The crisis could also exacerbate strife in areas left behind in the economic boom. It is tied to... economic worsening not only in the Czech Republic, but also in the rest of Europe, because attacks have happened in a number of other countries. There is unrest in society."[245]

In Hungary, attacks on the Roma were the most intense. On November 3, two Roma people were shot dead in Nagycsecs, in north east of the country.[246] On November 4, four other Roma were killed; the murders were attributed to extreme rightists.[247] By the end of 2008, more than seven Roma had been killed while Roma homes had received around 30 Molotov cocktail attacks.[248] Attacks have intensified in 2009. On February 23, two Roma people were shot as they were trying to flee their home, which was set on fire in Tatárszentgyörgy, a small town in the south east of Budapest.[249] On March 2, two more Roma were killed in Tatárszentgyörgy.[250] On April 22, two Roma people were shot dead, and his two others were seriously injured following a bombed attack on their home.[251] On April 29, a Roma man was shot dead in Tiszaloek, a town in the northeast of Budapest.[252] Budapest Times reports at least 16 other attacks on Roma homes in one year, and that only in one case the perpetrator

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243 Amnesty International, "March through Czech town puts Roma community in fear", 06.04.2009, http://www.amnesty.org/en/news-and-updates/news/march-through-czech-town-puts-roma-community-fear-20090406
244 "Roma protest demands Czech Republic stops growing extremism", *op.cit.*
245 Winfrey, *op.cit.*
246 "Two Killed In Attack On Roma Houses In Hungary", *Javno*, 03.11.2008, http://www.javno.com/en-world/two-killed-in-attack-on-roma-houses-in-hungary_199591
247 "Roma deaths link to far-right group", *News Scotsman*, 22.11.2009, http://news.scotsman.com/farrightineurope/Roma-deaths-link-to-.4721210.jp
248 Kulish, Nicolas, "As Economic Turmoil Mounts, So Do Attacks on Hungary's Gypsies", *New York Times*, 26.04.2009, http://www.nytimes.com/2009/04/27/world/europe/27hungary.html
249 Kulish, *op.cit.*
250 Omofoma, Ese, "Hungary Buries Two Roma Killed by Hate", *Impunity Watch*, 04.03.2009, http://www.impunitywatch.com/impunity_watch_europe/2009/03/roma-buries-two-roma-killed-by-hate.html
251 "Hungarian Neo-Nazi lead war on gypsies", *Russia Today*, 22.04.2009, http://www.russiatoday.com/Top_News/2009-04-22/Hungarian_Neo-Nazi_lead_war_on_gypsies_.html
252 Gorondi, Pablo, "Hungary's Gypsies targeted in deadly attacks", *Boston Times*, 29.04.2009, http://www.boston.com/news/world/europe/articles/2009/04/29/hungarys_gypsies_targeted_in_deadly_attacks/

was brought to justice.[253] The Hungarian President, on February 28, averred that the crisis had increased the urgency for Hungary to change the treatment of its Roma population after a series of attacks on the minority.[254] To comprehend the correlation between ethnic violence and the crisis, it is necessary to look at the social conditions in which the Roma live.

The largest Roma communities are located in the deprived areas of northern and eastern Hungary. In such regions, the Roma usually live in ghettos on the periphery.[255] The ghettos often host unemployed, welfare-dependent and uneducated Romas. The Roma are seen as a burden on the society. According to Robert Kushen, the director of the Budapest-based European Roma Rights Centre, “people accuse the Gypsies of living off the system; in good economic times, that leads to resentment. With the economy going south, it has led to rising tensions”.[256] So, the missing link between the crisis and ethnic violence is welfare deprivation and its financing. The crisis has exacerbated the problem by further trimming the already poor job opportunities. As mentioned earlier, this segment of the population was first to be laid off. Their chances to find a job have slimmed down as most of them are unskilled workers, and because of discrimination.

One reason why the Roma are scapegoated concerns the conviction that most crimes are committed by the Roma. The Roma are accused for most robberies and murders; they are stopped by the police and asked for their papers nine times more than other Hungarians.[257] The lack of ethnic monitoring in the country prevents the corroboration of this conviction on Roma criminality.[258] The extreme rightwing party Jobbik and its paramilitary group the “Hungarian Guard”, founded in 2007, have been accentuating the issues of “gypsy crime” and public security since the outbreak of the crisis. Jobbik and the Hungarian Guard, which argue the safeguard of Hungarian

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[253] Leitner, Attila, “Race War Feared”, *the Budapest Times*, 02.03.2009, http://www.budapesttimes.hu/content/view/11145/219

[254] “Hungary must change treatment of Roma – president”, *Reuters*, 28.02.2009, http://www.reuters.com/article/latestCrisis/idUSLS213893

[255] “Roma are scapegoats during downturn”, *op.cit.*

[256] Kushen, Robert, the director of the Budapest-based European Roma Rights Centre, in Dowling, Siobhán, “Hungary's Roma Bear Brunt of Downturn”, *Der Spiegel*, 24.02.2009, http://www.spiegel.de/international/europe/0,1518,609669,00.html

[257] Kushen, *op.cit.*,

[258] Stewart, Michael, anthropologist at University College London specialised in Hungary's Roma communities, in Dowling, Siobhán, “Hungary's Roma Bear Brunt of Downturn”, *Der Spiegel*, 24.02.2009, http://www.spiegel.de/international/europe/0,1518,609669,00.html

identity, culture and traditions,[259] picture the Roma as petty criminals who drain on social welfare systems. In December 2008, they held a rally against “gypsy crime” in Tiszalok and Tatárszentgyörgy. One rightwing protester of the rally, Istvan Kovacs, told IPS that “if they take welfare benefits and don’t work, they are more likely to keep stealing from people.”[260] It is noteworthy that using this issue has helped Jobbik boost its support near the 5% threshold for seats in Parliament in 2010.[261] In short, the Roma have been disproportionately hit by the crisis in economic terms; they also have been experiencing security problems.

Insecurity and welfare deprivation urged most Roma in the Czech Republic to seek asylum from Canada. In 2008, Canada received around 853 of such application, of them 84 obtained the status. Canada, reluctant to accept all these immigrants, called on Czech authorities to take measures to prevent Romani asylum claimants from arriving in Canada.[262] Also, Canadian Immigration and Refugee Board, an independent tribunal that evaluates refugee claims, sent a fact-finding mission to the Czech Republic in March to assess living conditions for Roma.[263] The status of the Czech Romani asylum was discussed at the Canada-EU summit of May 6.

The consecutive attacks on the Roma in Eastern Europe brought up the Roma question at the EU summit on December 11. The leaders decided to draw up an EU Framework Strategy for Roma Inclusion in an attempt to develop policies, and to improve coordination, monitoring, and evaluation between member states.

In sum, the financial crisis has exacerbated ethnic tension in Eastern Europe due to the deterioration of economic conditions and welfare standards. The Roma became the conspicuous target because of, mainly, welfare-dependence. The community has faced intensified attacks by extreme rightist who perceived the community as a burden on the society. The already existing ethnic prejudices have sustained the

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[259] Kulish, Nicholas, “Hungarian Extremists Reflect Discontent, and Add to It”, *the New York Times*, 24.10.2009, http://www.nytimes.com/2007/10/24/world/europe/24hungary.html

[260] Dujisin, Zoltán, “Roma Pay the Price for Far-Right Rise”, *Inter Press Service*, IPS, 29.12.2008, http://ipsnews.net/print.asp?idnews=45242

[261] Kulish, *op.cit*.

[262] European Roma Rights Center, “Rights Coalition Calls on Canada to Take a Leading Role in Protecting Czech Roma from Persecution”, the official website, 05.05.2009m, http://www.errc.org/cikk.php?cikk=3031

[263] “Canada calls on Czech govt to stop Roma refugees”, *Aktualne*, 16.04.2009, http://aktualne.centrum.cz/czechnews/clanek.phtml?id=634843

welfare argument. Although discrimination towards the Roma has been widespread in the region, the most frequent attacks occurred in the Czech Republic and Hungary. Particularly in Hungary, ethnic violence was the most intense. That Hungary was the country that was the worst hit by the crisis strengthens the thesis that the crisis has created ethnic tension in society due to welfare deprivation. On the other hand, this thesis falls short to explain why ethnic violence has exacerbated in the Czech Republic that has showed a relatively good crisis management performance. The Czech exception therefore, is illustrating for exposing the limits of economic explanations. Comparative politics, anthropology or sociology certainly, have more to say in this regard.

Let us now recapitulate the main findings of this chapter. As the financial crisis has spread over the real sector, people's daily lives were affected. Layoffs, wage cuts and uncertainty have instigated social discontent in Europe. Dissatisfaction was channelled mainly by protests, strikes and demonstrations in the Union. However, in the non-Eurozone countries where economy was hardly hit, these forms of protestation turned into violent clashes, riots and attacks on ethnic groups. Hungary, Latvia, Lithuania, Romania fall into this category. The heavier were the macroeconomic impacts of the crisis the more violent were the contestations. In effect, in the NMS that have better withstood the crisis, social discontent was not of a violent nature. Countries such as Slovenia, Slovakia or the Czech Republic exemplify this group. On the other hand, the crisis fuelling social dissatisfaction has aroused political instability in the region; which the collapse of three NMS governments illustrates. The change of cabinet occurred in the countries where the macroeconomic and social impacts of the crisis were the hardest. Latvia and Hungary feature in this category. Finally, the crisis has rekindled the dormant ethnic hostilities. Although hostility was widespread, in Hungary and the Czech Republic it took the form of violent attacks against ethnic minorities. The finding on Hungary suggests that ethnic costs were the highest in the countries where the macroeconomic, social and political costs were the highest. On the other hand, the Czech Republic is an outlier in various respects. The country performed well in the crisis; still it has undergone cabinet change and ethnic violence, but not social contestation of a violent nature. As such, the Czech Republic makes a rather interesting case study. However, its explanation

requires some deeper political, economic, sociological and historical analyses that pass beyond the scope of this thesis.

Chapter V

CONCLUSION

This thesis has analysed the impacts of the 2008 financial crisis on EU integration and solidarity. The objective was to identify the state actors' and the Commission's reactions to the crisis, in the context of multilevel governance, whereby to understand whether the Union could withstand the turmoil in unity and solidarity. The main hypothesis of the thesis was that the EU's economic and financial solidarity was vulnerable to individual interests of member states, and particularly to those of France, Germany, Italy and Britain. The hypothesis was tested at two levels, the EU level and the state level, states referring to the new member states.

The first chapter of the thesis dwelled upon the EU level actions. It sought to identify whether the EU actors could develop a common coordinated EU level strategy in coping with the crisis. The analysis concluded that the EU actors developed, in relatively a short period of time, a common action plan, the European Economic Recovery Plan, and guidelines alongside. The process was kicked off by the state actors, upon the cues given by France, Germany, Britain and Italy. The EERP and the accompanying common measures were compiled in such a way that they would address mostly the problems on the Eurozone economies. This outcome produced two types of problem in the Union. Firstly, during the implementation period, France attempted to adopt a protectionist bailout plan, thereby to break EU solidarity and the competition rules in the market because of domestic interests. This initiative was aborted, mainly, upon contestations by other member states whose interests would be undermined by the French bailout plan. This example has demonstrated, first, poor coordination within the Union, second, the weakness of EU solidarity. This is an important finding of the thesis as one of the founding members has created a major setback to European economic integration by protecting its individual interests. The other problem that emerged in this process was the divide between the Eurozone and non-Eurozone members. Because common measures and

the EERP only partly addressed problems in the context of Central and Eastern Europe, the non-Eurozone members asked additional financial assistance from the EU, and early facilitated accession to Euro area. The Commission and the Eurozone members declined both demands for economic reasons. As a result, the new member states contested the decision on the grounds of inequality between member states. The old members revised the first demand at the European Council meeting of March 20, 2009, by deciding to bail out countries in turmoil on a case-by-case basis. This chain of events indicated three main conclusions with regards to the Union's governance. Firstly, the concerns of the old members mark EU level actions. In other words, the powerful members influence EU level policies that would apply to all members. Secondly, it has thus become apparent that there is a divide between the old and new member states. Thirdly, neither the old members nor the new member states always stick together; mainly because member states decide to support or disjoin their peers according to the needs and problems at the domestic level. On the other hand, the predomination of decision making by Western members gives the new member states incentive for acting together. All these patterns are of a nature to oppugn the solidarity claim in the Union, thereby to support the main hypothesis that EU solidarity is vulnerable to the individual interests of the older members, precisely those of Germany, Italy, France and Britain. The conflicts of interests in the EU decision making process communicate that the new member states are not yet as powerful as to counterpoise the weight of the old members. In other words, the already existing pattern of 'predomination by France, Germany, Italy and Britain' has not altered after the Eastern enlargement. The crisis has thus exposed that economic integration and financial solidarity were vulnerable to domestic interests of state actors; and those of the four old members in particular. This finding is revealing to demonstrate the limits of integration.

The second chapter considered the impacts of the crisis in the context of Central and Eastern Europe. The objective was to gauge the extent to which the EU level actions have satisfied the needs and have remedied the problems in the new member states context. The analysis established that the crisis has showed an uneven impact on the new member states economies; some members were hit more than others both economically and politically. The countries that were the hardest hit were Hungary,

Latvia, Bulgaria, followed by other Baltic states and Romania. The other members circumvented collapse thanks to, mainly, sounder macroeconomic policies that they had adopted prior to the crisis. Thus, one of the key findings of the thesis was that the reason motivating the Eurozone members' objection to a region-wide bailout plan was accurate; the situation was not as bad everywhere as it was in, say, Hungary. However, the study also uncovered that the crisis has engendered deeper problems in the new member state economies. The Eurozone members in fact, have enjoyed the advantages of using euro and of having more industrialised and wealthier economies. In contrast, the non-Eurozone members not only were deprived of the advantages of the Western member, but also had little to gain from common measures. As a result, they formulated additional demands from the EU. In other words, the domestic needs and problems have orientated the new member states' position within the EU, meaning vis-à-vis the old members and their peers. On the other hand, the crisis has channelled social dissatisfaction with the domestic economic and political situation across Europe. However, this dissatisfaction also varied with respect to the impact of the crisis on individual members. The countries whose economies were the hardest hit saw the highest level of popular discontent. In the countries where economic situation was worse, discontent took the form of social unrest, but of a violent nature. In the new member states where economic performance was better, protests were intense but not violent. So, in a way, social costs were shaped by economic damages; where the latter were heavier, the former scored high. In addition, poor crisis management performance led to government instability as illustrated by the collapse of four governments in the new member states by the end of the first quarter of 2009. Finally, the crisis seems to have enkindled the dormant ethnic hostilities in the new member states. Welfare deprivation aggravated by the crisis has instigated attacks on the Roma communities in Eastern Europe. Ethnic violence was particularly intense and frequent in Hungary and the Czech Republic. The case of Hungary strengthens the validity thesis that economic deprivation is likely to engender social and ethnic costs. In contrast, the Czech case weakens the claim since the Czech Republic is one of the best performing new member states in the fight against the crisis. In other words, the fragile political situation in most new member stats was prone to instability and ethnic strife partly as a result of economic problems caused by the financial crisis.

So, this thesis argues that the findings are important for shedding new light onto the integration literature, as well as on the literature on International Relations. Firstly, they reaffirm the already existing claim that EU governance is dominated by the relatively more powerful members, more specifically by France, Germany, Britain and Italy. The Eastern enlargements have expanded the size of the Union; but the crisis has showed that the balance of power amongst the member states has not much altered. The disequilibrium arouses criticism by the new member states about inequality in the EU. This finding falls in line with the assumptions of the neorealist theories of International Relations stating that the interests of the more powerful states overweigh the interests of the relatively weaker states, and that the former are more influential in shaping world politics than others. Secondly, state actors turn to EU level actions when they need to. When national interests conflict with the EU level strategies member states attempt to break solidarity and common rules in the Union. This finding is in accordance with the assumptions of liberal intergovernmentalism, and those of the neorealist theories. In that, the main interest of states is survival. The relatively more powerful state actors do cooperate when the benefit from cooperation is greater than the benefit of unilateral action. Finally, multilateral actions in the form of cooperation are vulnerable to state interests even if cooperation has been going on for some time. In sum, the crisis has exposed the vulnerability of economic integration and financial solidarity to individual interests. It also has exhibited the problems of coordination and accommodation of the NMS within EU governance. If the EU wants to progress integration in a healthy and sound way, it needs to reconsider the critique of inequality, thereby the issue of solidarity within the Union.

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