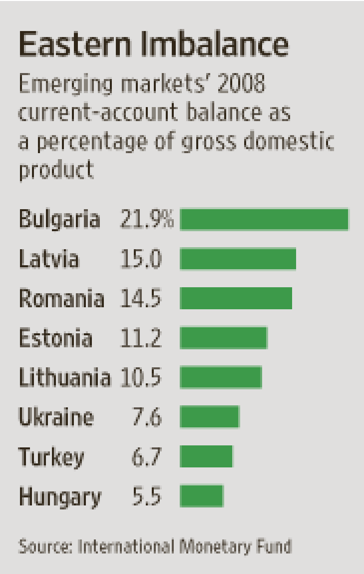
THE WALL STREET JOURNAL | BUSINESS NEWSREEL

OCTOBER 11, 2008

Eastern Europe Feels Heat From Meltdown

By MARCUS WALKER

After Iceland's financial meltdown, investors and lenders are pulling back from financially overstretched economies in Europe's East, threatening to burst credit bubbles in the Balkans and force harsh downturns in Hungary and the recently booming Baltic states.



Stocks, bonds and currencies came under pressure Friday in many of Europe's post-Communist countries, driven by concerns that the crisis in West European and U.S. banking is poised to hit Central and Eastern Europe next.

Hungary's markets and currency took a particular beating, following a collapse in government bond trading Thursday and rumors of an impending state bailout of the country's largest bank, OTP Nyrt, which the bank and Hungary's government denied.

A string of countries around Europe's periphery are threatening to fall victim to investors' rising risk aversion. Many have relied heavily on borrowing from abroad to finance their business activity and consumer spending.

Now that the days of cheap credit are over, these countries face a painful economic contraction as they learn to live within their means again as investors flee countries with large external financing needs.

"Their chickens are coming home to roost, because of the current-account deficits and government deficits they've been running. These things simply aren't possible in today's world," says one London-based fund manager who has been selling Eastern European currencies and other assets short.

None of the Central and East European countries are likely to face as severe an implosion as Iceland, where the government has warned of possible "national bankruptcy" after it was forced to take over all of the country's major banks, economists say.

Most banks in Central and Eastern Europe are units of large international financial groups based in Western European countries such as Sweden, Austria and Italy. That frees small East European nations such as Estonia from having to bail out their main domestic lenders single-handedly, like Iceland. But it also leaves local subsidiaries exposed to a cutback in funds from their foreign parent-banks.

"Iceland was a special case," says Reinhard Cluse, emerging-Europe economist at UBS AG in London. "But the same rising waters that flooded Iceland first are a problem for others, too."

Many consumers and businesses have large debts in foreign currencies taken out to exploit the relatively low interest rates that were available in euros, Swiss francs or yen. Many Hungarians could now find their foreign-currency mortgages are a growing financial burden as the local currency, the forint, sinks. "Borrowers can sustain some pain for a while, but not if these levels stay," says Mr. Cluse.

Hungary's economy is the weakest in Central Europe, thanks to the government's tax increases since 2006, which were aimed at repairing the country's deteriorating public finances.

The Hungarian forint weakened to about 256 to the euro in Friday's trading, compared with around 230 in July. If the forint sags further, Hungary's central bank will probably raise rates to support the exchange rate, says Hungary economist and consultant Tamas David-Barrett. "That would of course mean people who borrowed in forint will be in trouble as well," he says.

The credit bubble has already burst in Estonia and Latvia, where roaring growth rates of around 10% in recent years have given way to recession. Much of the growth was in the retail and construction sectors, where cheap credit was the fuel.

Once-booming young businesses in these countries are starting to fail as sales dwindle and banks pull the plug. Nova Haus Element AS, an Estonian maker of houses, won a "developer of the year" award in 2007 from Estonia's chamber of commerce and employers' association. Last month it went bust amid heavy bank debts as the Estonian housing market sank.

"There are going to be some pretty big casualties among companies in property-related sectors and retail," says Joakim Helenius, founder of Trigon Capital, an investment firm based in Tallinn. Latvia too faces a wave of business failures in coming months, he says, since the country's economy, like Estonia's, has overrelied on the retail and construction sectors in recent years.

The third Baltic country, Lithuania, is in somewhat better shape than its neighbors thanks to less-excessive borrowing by firms and consumers, and a stronger export sector.

Central European countries such as Poland, the Czech Republic and Slovakia are also further down the list of crisis candidates, because their growth in recent years has been fueled by exports to Western Europe, rather than real-estate and consumer bubbles. But these economies face slower growth as foreign-owned banks cut back lending and consumer demand slows in their main markets, such as Germany.

The credit crisis has barely started to hit home yet in Romania and Bulgaria, where economic growth accelerated in the second quarter, in contrast to downturns elsewhere in the region. But funding for real-estate developments and mortgages is now starting to dwindle.

News of the global banking crisis is already pricking Romanians' bubble. Some wealthier locals have already taken their money out of banks.

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