Economic Woes in Eastern Europe Deepen

Insights
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Last week's resignation of Bulgaria's government highlights the economic and political struggles plaguing Europe's eastern flank, and the risks for investors and companies looking to do business in emerging economies. Unemployment in the eastern European countries is generally high, and recent data show no relief is in sight. Making matters worse, the austerity programs put in place to woo foreign investment have led to social unrest, such as in Bulgaria, making investors skittish and less willing to invest.

It is not the austerity programs alone, however, that have led to seeming never-ending recession and public unhappiness. Two countries illustrate the challenges faced by the emerging economies of eastern Europe. Both Hungary and Bulgaria have educated and skilled workforces, and their central locations in Europe and low labor costs make them ideal candidates for employers looking to expand operations. Unfortunately, both countries have been held back by government mismanagement and corruption.

Bulgaria
The Bulgarian resignation was preceded by protests around the country, sometimes violent, expressing widespread anger over austerity policies and ongoing recession. Austerity measures are not the only factor contributing to Bulagria's problems. In addition to harsh austerity policies, Bulgaria suffers from rampant corruption and the malign influence of organized crime. Although Bulgaria began the economic crisis with a balanced budget and austerity measures have been relatively mild as compared to those of other countries like Greece, government corruption and mismanagement and a corrupt legal system have continued to deepen the economic crisis there.

Bulgaria touts itself as an investment haven by promoting its ten percent flat tax and educated, skilled workforce, but it does not appear those attributes have had much influence on foreign investment. Bulgaria is still excluded from the European Union Schengen zone (permitting passport free travel among members) and its justice system has been under the oversight of the EU because of corruption allegations. The average monthly salary in Bulgaria is less than half the EU average, and its official unemployment rate, which hovers around twelve percent, is thought to be artificially low because of the thousands of Bulgarians who have been unemployed so long they no longer receive unemployment benefits. Bulgaria has been ranked 66 out of 185 places in ease of doing business (according to the World Bank), and although reforms were planned for 2013 to improve its ranking, its government position leaves those reforms very much up in the air.

The catalyst for the recent protests was a sharp increase in heating and electricity costs, the costs of which rose to more than half the average monthly salary and two-thirds or more of the average pension. Embattled, the prime minister promised to reduce electricity costs by eight percent, but gave no explanation as to how he would do so. Resorting to xenophobic tactics, the departing prime minister vowed to revoke the power distribution license held by a Czech company. Indeed, many of the protests in the past few weeks appeared to take on a nationalistic tone, which can only serve to further scare off foreign investment and employers hoping to capitalize on the educated, skilled, and low-cost workforce.

Unfortunately, desperately needed reforms to the energy sector have been put on the back burner, with the government's resignation leaving the country's governance in disarray, and countrywide protests have not ended. It remains to be seen whether in the current climate Bulgaria will be able to attract and keep foreign investors.

Hungary

An increasingly volatile and autocratic government in Hungary has exacerbated already difficult conditions there. In addition, effective January 1, 2013, regulations regarding the enforcement of the new Labor Code and regulations modifying 68 legal acts, including multiple employment laws, came into effect, creating compliance challenges for many employers.

Although the reasons for Hungary's continuing malaise are slightly different than in Bulgaria, it too has been suffering from an exodus of capital and decreased investment. Prime Minister Viktor Orban recently imposed Europe's highest banking tax and has threatened to boost taxes even further on foreign owned retailers and utilities. Hungary's economy shrunk for the fourth consecutive quarter, contracting 2.7 percent from October to December 2012. The European Commission projects a budget deficit of 3.4 % GDP both for 2013 and 2014, making it even more difficult to leave the EU's excessive deficit procedure, something it is eager to do. In addition, the EU projects a 0.1% GDP contraction for Hungary in 2013, which Hungary disputes. Hungary responds that it expects one percent growth in GDP in 2013, although it is unclear what factors would drive that projected growth.

Much like his former counterpart in Bulgaria, Orban's Fidesz party attempts to stir up nationalist fervor, with party officials publicly making nationalist, anti-Semitic, and anti-Roma remarks, with one prominent columnist with government ties calling for a "final solution" for Hunagary's Roma population.

The EU has accused Fidesz of making undemocratic changes to the judicial and banking systems and for making constitutional changes to the voting system which potentially has the effect of keeping thousands of voters from the polls. Further, Orban's policies have turned the Hungarian media into a highly-controlled mouthpiece for the government, with very little room for independent or critical voices. In response to EU and international criticism, Orban complains that the EU is trying to control Hungary and has threatened to turn down EU economic assistance. It remains to be seen whether the EU will actually impose any meaningful sanctions on Hungary, as its track record on such issues is generally poor. In the meantime, Hungarians, much like their Bulgarian neighbors, will continue to suffer through government mismanagement and corrupt rule.

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