# The East European Financial Crisis: Causes and Cures

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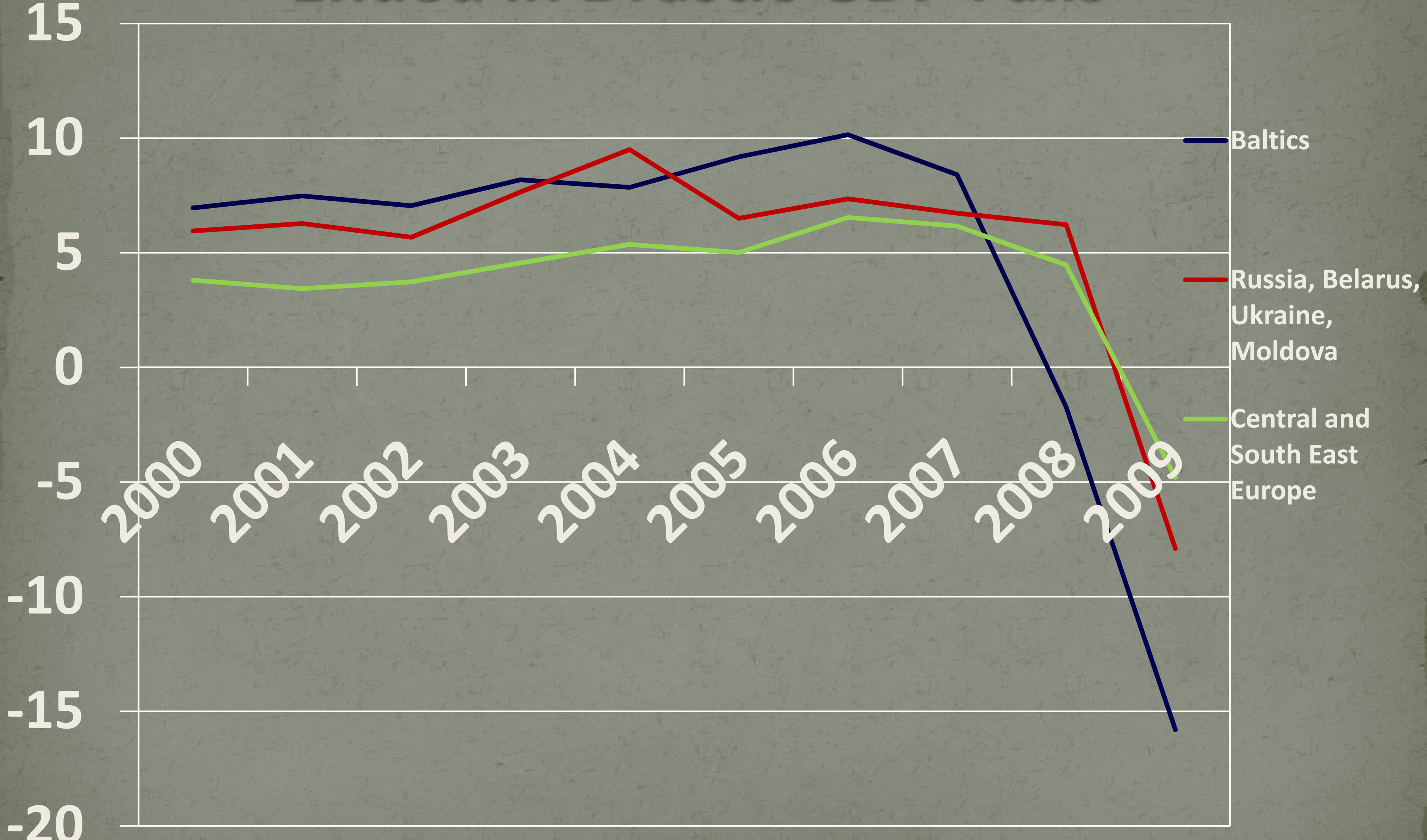
April 8, 2010

# THESES

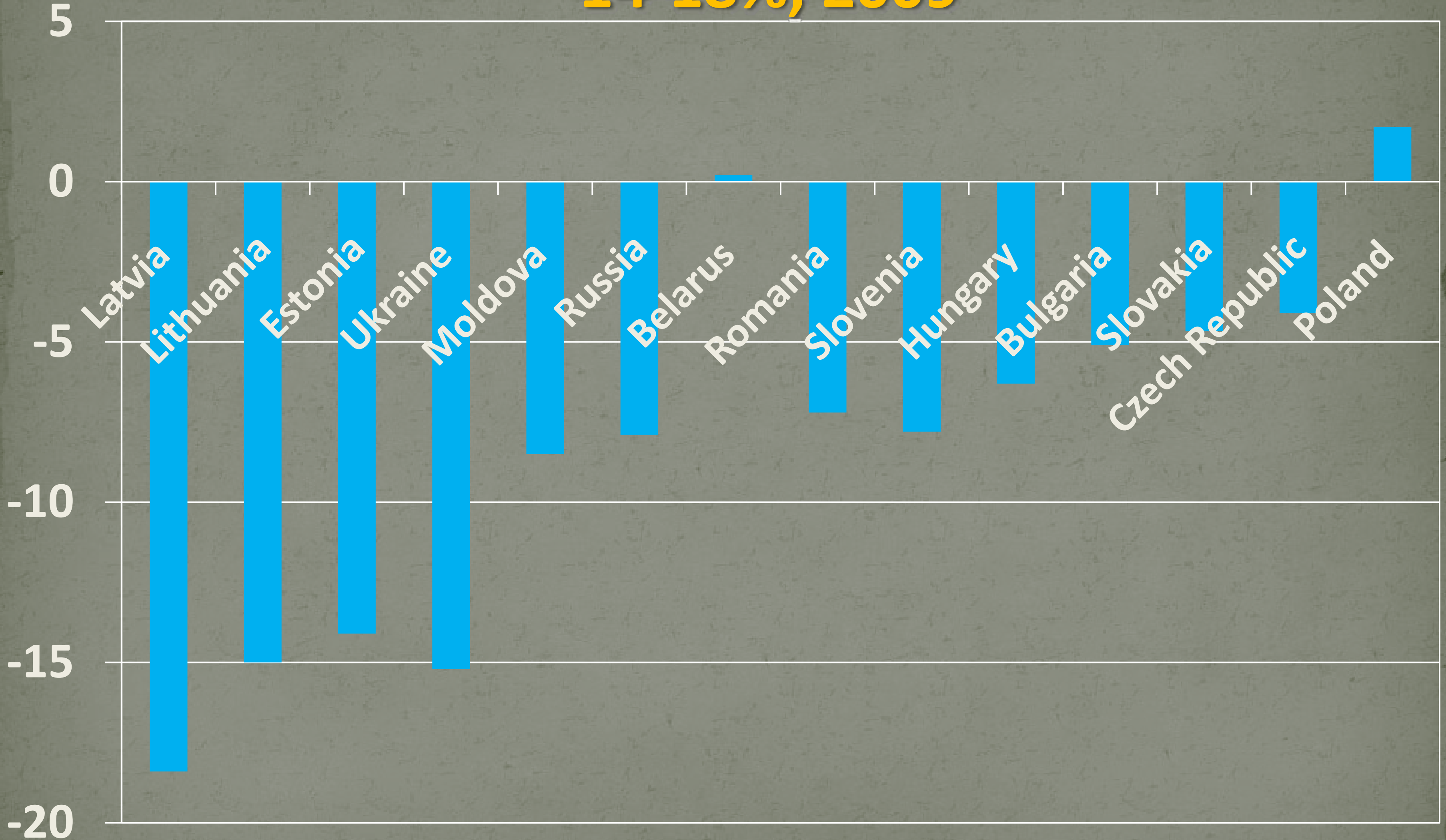
1. Problems: Overheating = Current account deficit, foreign debt, credit expansion, and inflation
2. Cause: fixed exchange rates but no euro
3. Sudden stop & huge GDP falls, but quick recovery: it is time to declare victory
4. Capitalism held, merely a current account crisis

# A Long Boom 2000-2008
# Ended in Drastic GDP Falls



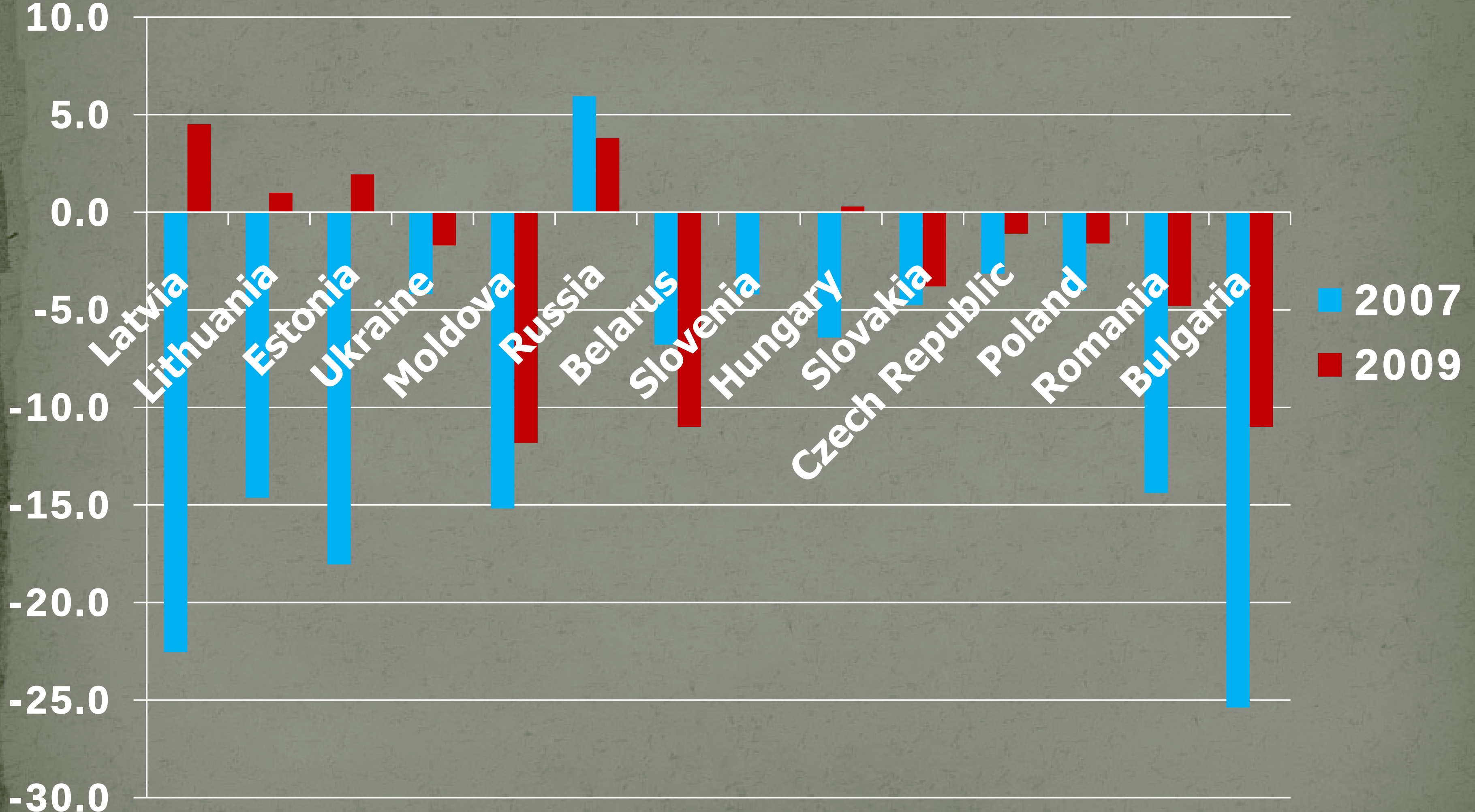

*Source:* EBRD, IMF, JP Morgan, CISstat, Eurostat

# Big GDP Declines in Baltics and Ukraine: 14-18%, 2009



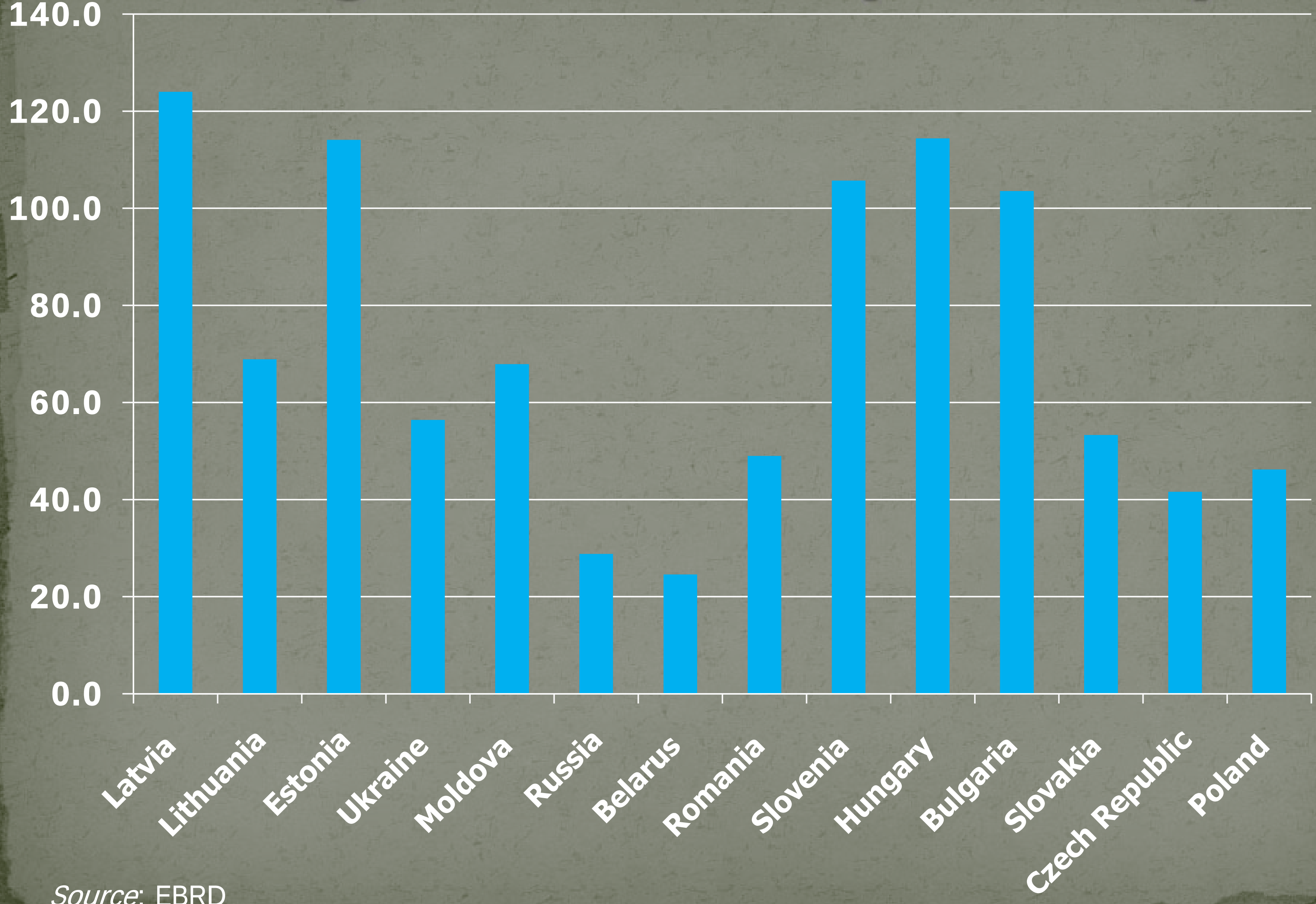

*Source:* JP Morgan, CISstat, Eurostat

# Huge Current Account Deficits - mostly eliminated



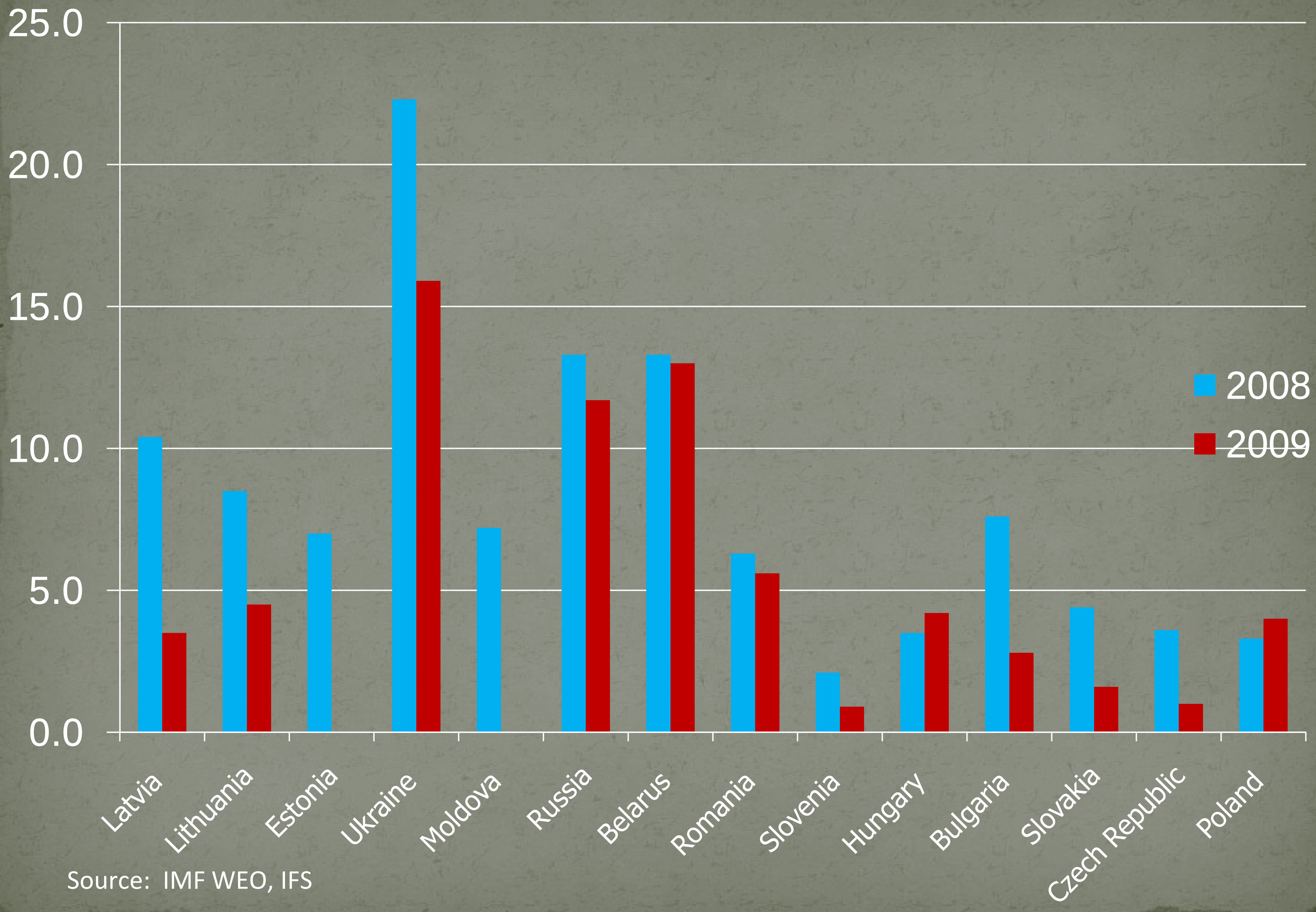

Source: EBRD, OECD, JP Morgan

# Five Countries
# Foreign Debt > GDP (end 2008)



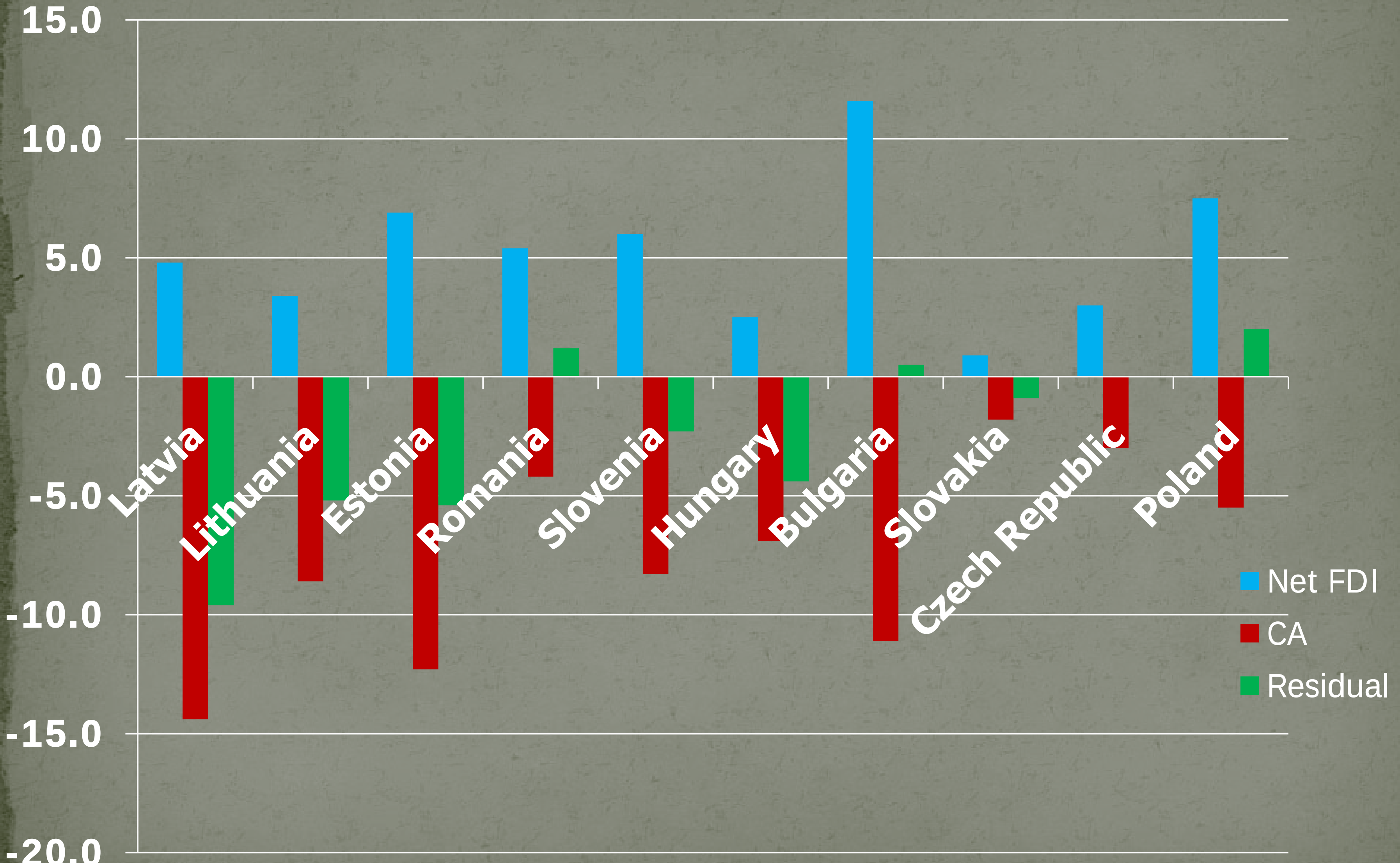

*Source*: EBRD

# Mostly High Inflation: Now Low



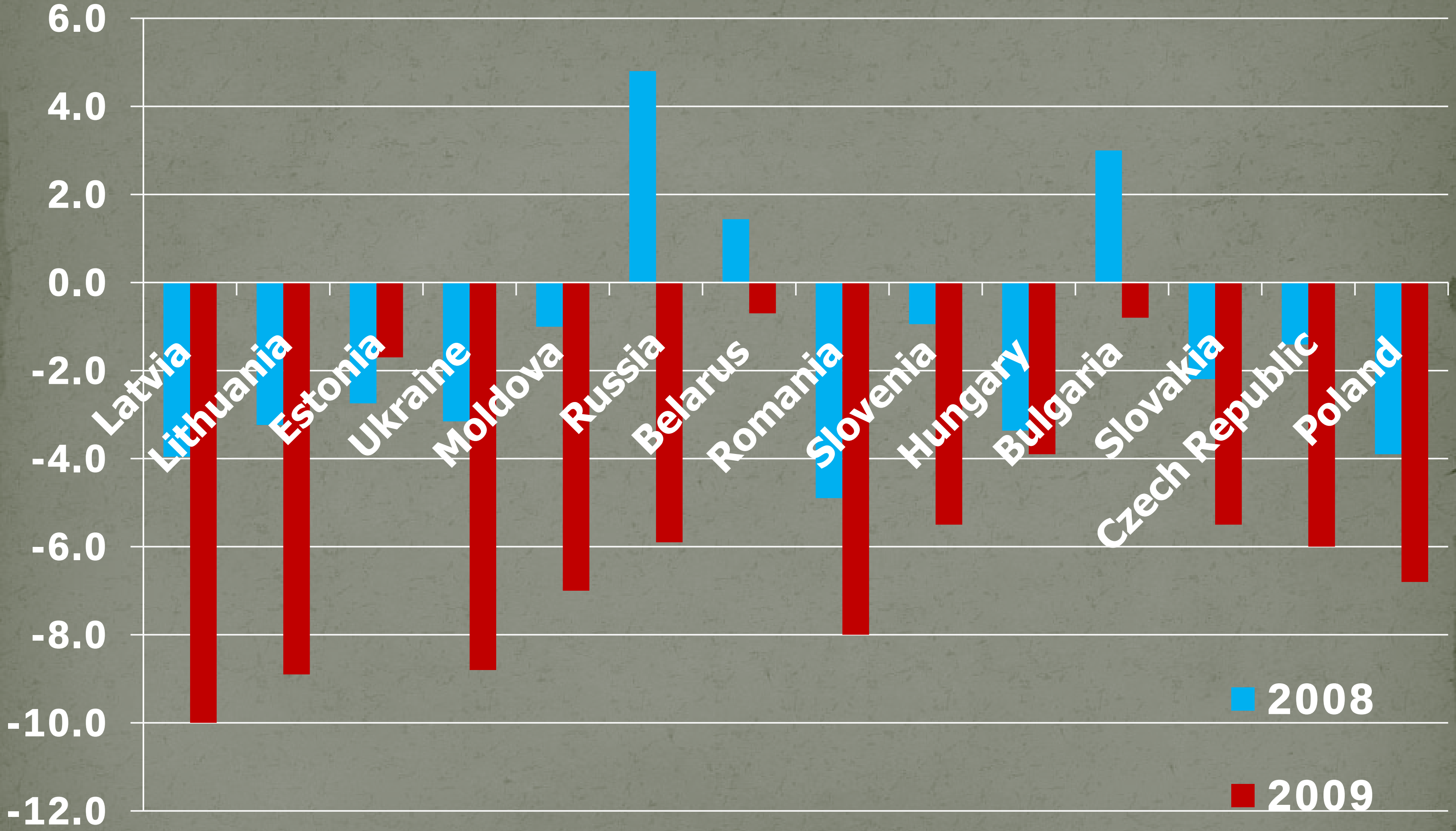

Source: IMF WEO, IFS

# Current Account Deficit Dangerous when more than Net FDI, 2002-07




*Source:* Darvas, Zolt, and Jean Pisani-Ferry (2008)

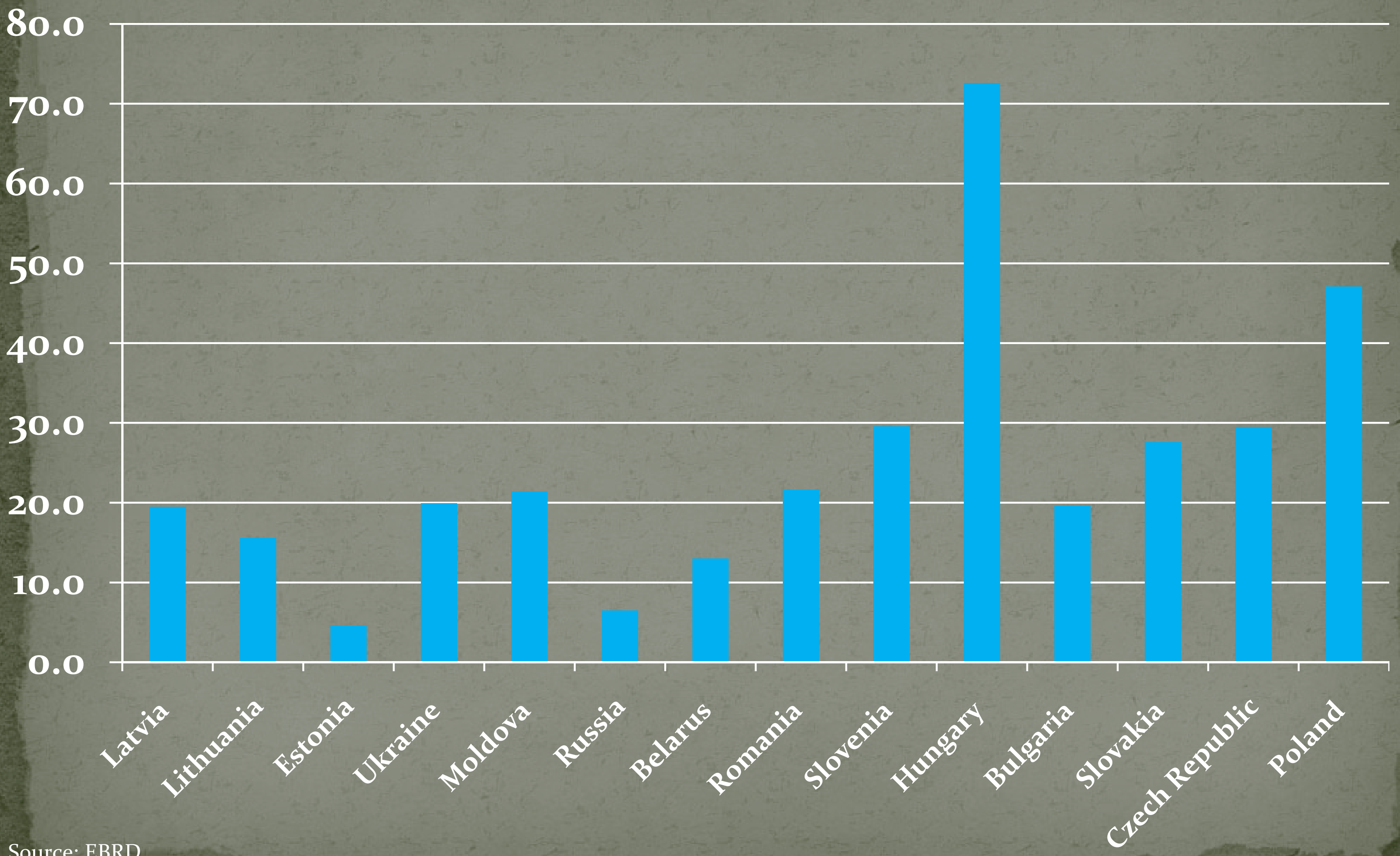
# Good Budget Balance before Crisis, Still Reasonable




*Source:* EBRD, JP Morgan, CISstat. 2009 data for Ukraine excludes Naftogaz

# Very Low Public Debt, 2008

## High Only in Hungary




Source: EBRD

# Poland Had No Crisis

No GDP decline because of excellent Central Bank policy:

- Inflation targeting: persistent low inflation because of positive real interest rates
- Floating exchange rates impeded currency inflows
- Checked credit expansion and house prices
- Regulated away mortgages in euro

Because Leszek Balcerowicz ran the National Bank in the early 2000s.

Good institutions work only with good leadership.

# IMF

- 6 standby programs: Hungary, Ukraine, Latvia, Moldova, Belarus, Romania
- Faster than usual
- Back to basics: exchange rate, budget and bank restructuring
- More money than usual (edged out the World Bank)
- Learned its lessons from East Asia 1997–98

Successful

# European Union

- Cofinanced IMF program
- Also adjacent member countries cofinanced
- Fast and few conflicts

Also successful

# ECB

- Played no overt role
- Offered credit swaps only to Sweden and Denmark
- Should have facilitated euro expansion

Needs to revise its actions

# Lessons: Exchange rate crucial

1. Avoid dollar pegs (Ukraine)
2. The currency boards lack credibility (Baltics and Bulgaria)
3. Inflation targeting works well (Poland and Czech Republic)
4. The euro credible even when unilaterally adopted as in Kosovo and Montenegro

Seize the euro or pursue inflation targeting

# Lessons (2)

1. Estonia and Bulgaria have salvaged themselves through persistent budget surpluses, but GDP fell sharply.

2. The IMF and the European Commission worked well while the ECB did nothing.

# Conclusions for the Future

1. The East European crisis has been well handled: All but Baltics are growing now.
2. All should rush to the euro because ECB supports only euro countries.
3. Early euro adoption desirable for the currency board countries: Estonia 2011?
4. Inflation targeting and shortened ERM II desirable for the other EU members.

Europe's present problem is the south, not the east.