The Last Shall Be the First: The East European Financial Crisis, 2008-10

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Hiiumaa
Saaremaa
ESTONIA
Gulf of Riga
Riga
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RUSSIAN FEDERATION
BALTIC SEA
ARK
LITHUANIA
RUSSIAN FEDERATION
Vilnius
BELARUS
RMANY
POLAND
Warsaw
Prague
CZECH REPUBLIC
UKRAINE
SLOVAKIA
Bratislava
AUSTRIA
Budapest
HUNGARY
REP. OF MOLDOVA
Ljubljana
SLOVENIA
ROMANIA
CROATIA
Crimea
BOSNIA AND HERZEGOVINA
Bucharest
SERBIA
BLACK SEA
ADRIATIC SEA
MONTENEGRO
BULGARIA
Sofia
FYR MACEDONIA
ALBANIA

THESES

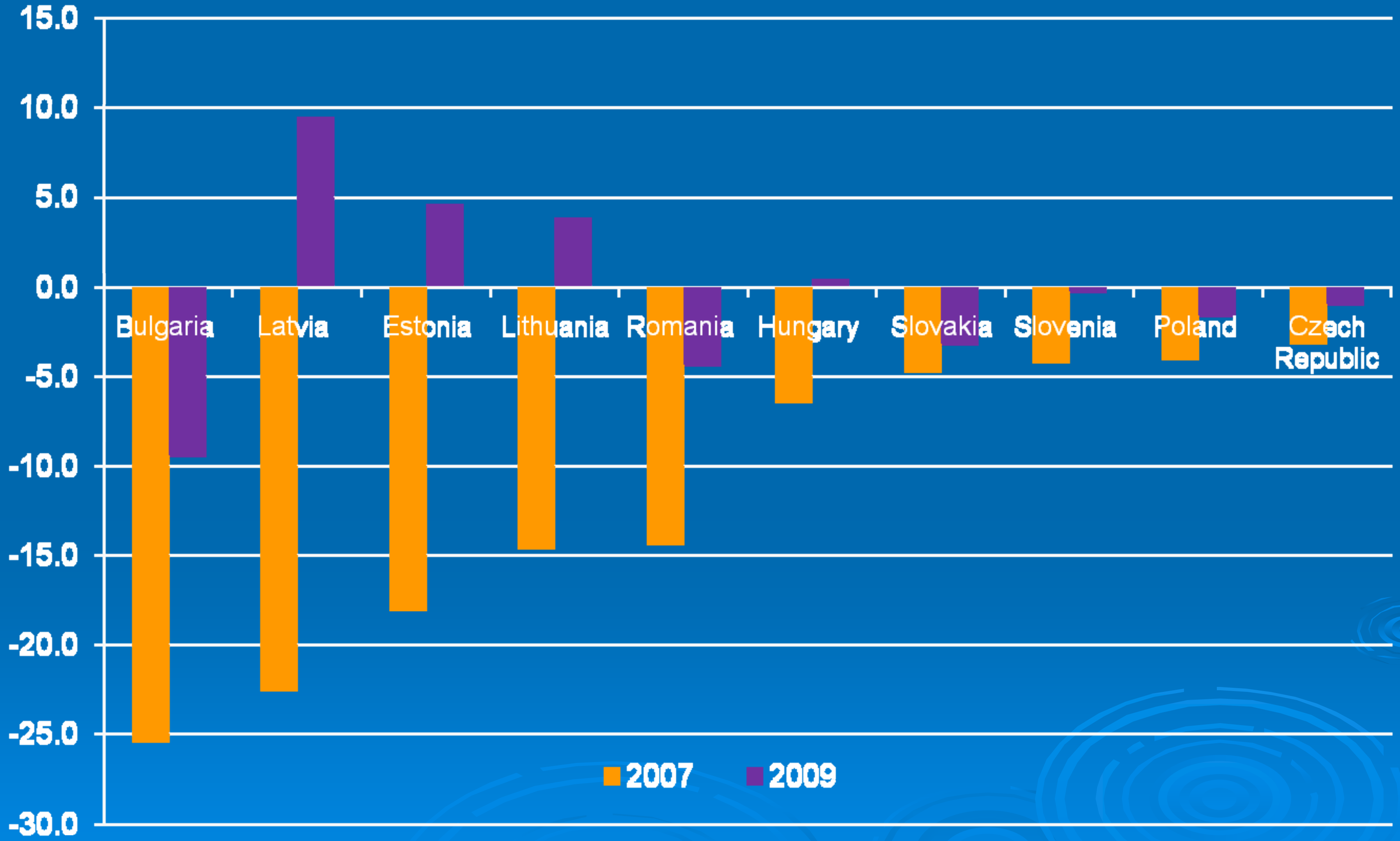
- Standard credit bubble
- No change in exchange rate regime
- Excellent political economy
- Good crisis resolution by governments, IMF, and EU

Causes of the Crisis

- Loose monetary policy of the US Fed and European Central Bank (ECB)
- Excessive capital inflows (carry trade)
- Excessive credit expansion
- Real estate bubble
- Rising inflation
- Current account deficit
- Small currency reserves

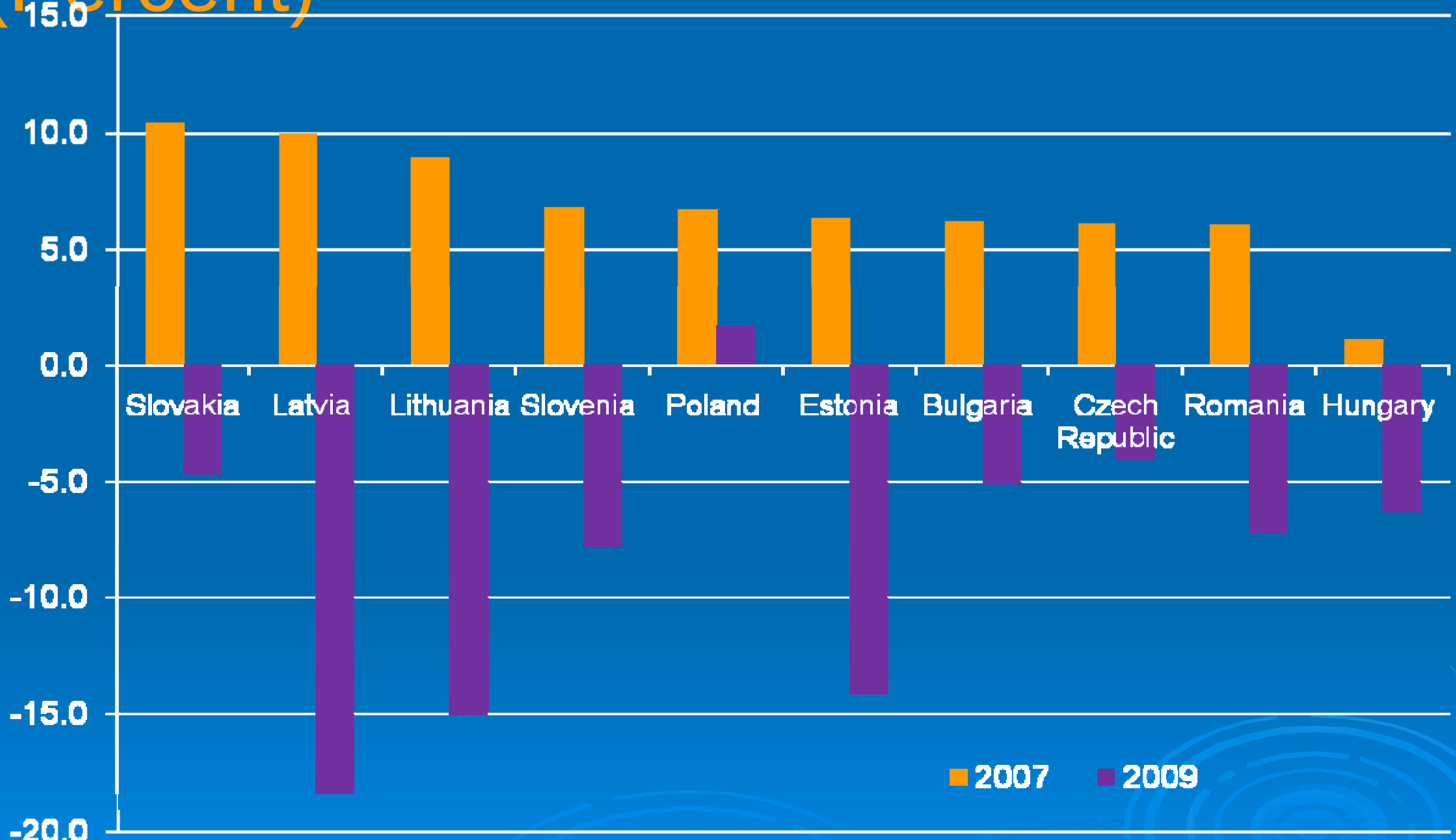
But decent public finances and little leverage

Current Account Deficit, 2007 & 2009
(Percent of GDP)



GDP Growth 2007 & 2009

(Percent)



Exchange Rate Regimes

- Euro: Slovenia & Slovakia: no crisis
- Currency Board: Estonia, Latvia, Lithuania & Bulgaria: Biggest output slump
- Floating Exchange Rates: Poland, Czech Republic, Hungary, & Romania: Mixed results

Currency Boards

- Most overheating: No means to stop or sterilize capital inflows
- But best fiscal policy
- Biggest GDP slumps
- But only one IMF program needed
- Internal devaluation works

All want the euro early: Estonia 2011

Inflation Targeting

- Poland & Czech Rep: Ideal monetary and exchange rate policy
- But Hungary & Romania needed IMF programs
- Poorer fiscal policy, especially in Hungary

Less interested in early euro adoption

Conclusion

- Ultimate problem: Loose monetary policy of US Fed and ECB
- No exchange rate regime could salvage these open and attractive economies
- No country changed exchange rate regime as no evident advantage

Political Economy

- Minimal unrest: Populism not popular
- Cuts of 8-10% of GDP (Baltics) politically easier than 2% of GDP
- People have demanded realistic, radical crisis resolution

Political Economy 2

- 8 of 10 countries have changed government during the crisis
- 9 of 10 countries have center-right governments – center right stronger than ever
- Multi-party coalitions most effective in crisis

IMF: Stronger than Ever

- Seized initiative with speed
- Had and gave more money than ever
- Fewer conditions: Back to old Washington Consensus
- Accepted and financed large temporary budget deficits

European Union: The Rookie

- Let the IMF lead
- Substantial co-financing
- Checked IMF – insisted on pegged exchange rates and financing for Latvia

Other International Players

- The United States: Keeping a Low Profile
- World Bank: The Third Fiddle
- EBRD & EIB: Bank restructuring
- European Central Bank: Voldemort

How ECB Should Change

- Abridge ERM II period
- Set a floor for inflation (2% a year)
- Offer credit swaps to EU countries

(Darvas and Pisani-Ferry 2008)

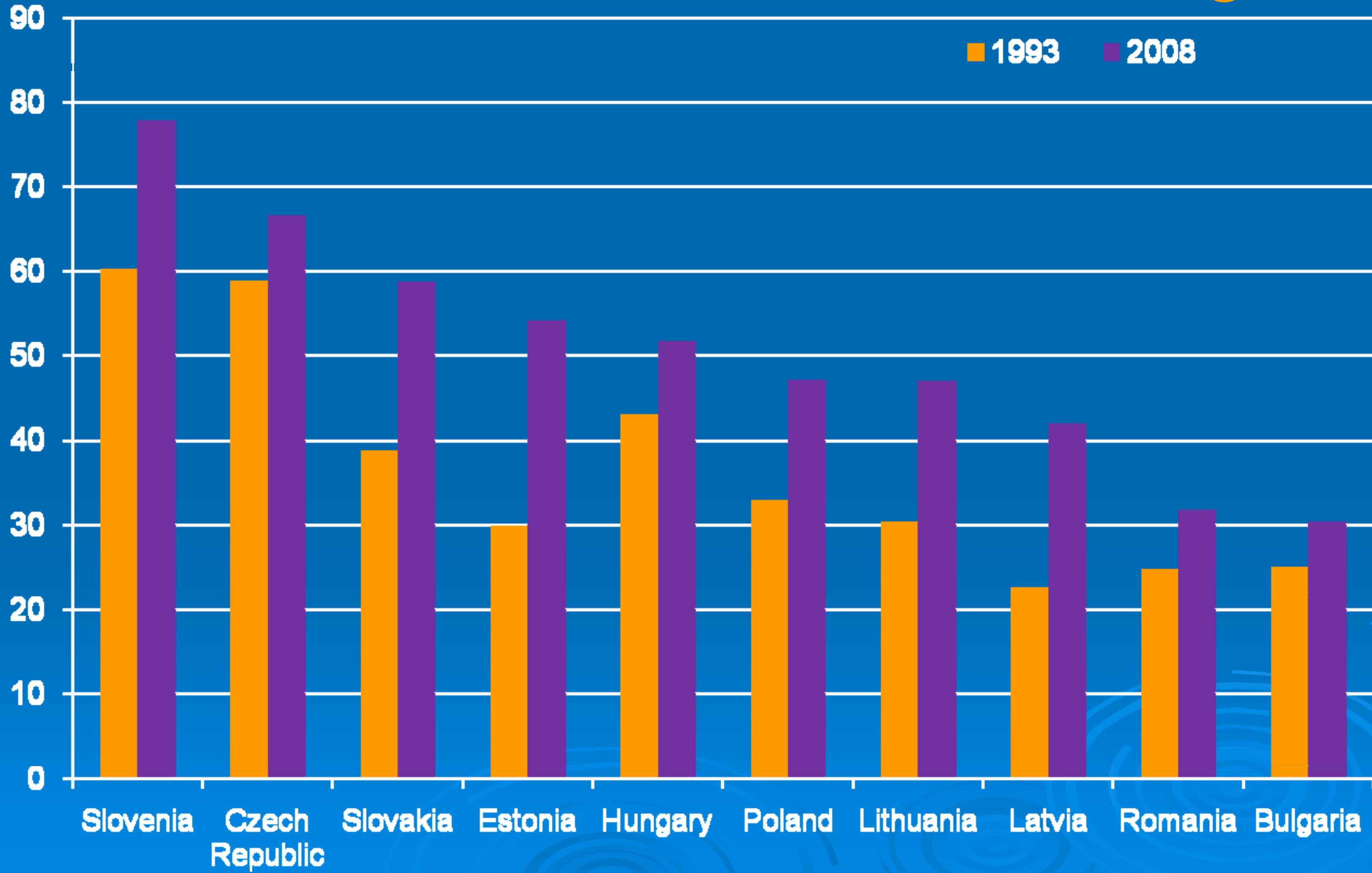
Outcome and Outlook

- Trimmed public sectors: Expenditure cuts rather than higher taxes
- Minimal changes in pensions – main problem
- Unchanged liberal tax policy: 7 have flat income taxes
- Eastern Europe has gained efficiency and self-confidence: European convergence

The Last Shall Be the First

European Convergence

GDP in PPP as % of EU Average



THE LAST SHALL BE THE FIRST

THE EAST EUROPEAN FINANCIAL CRISIS

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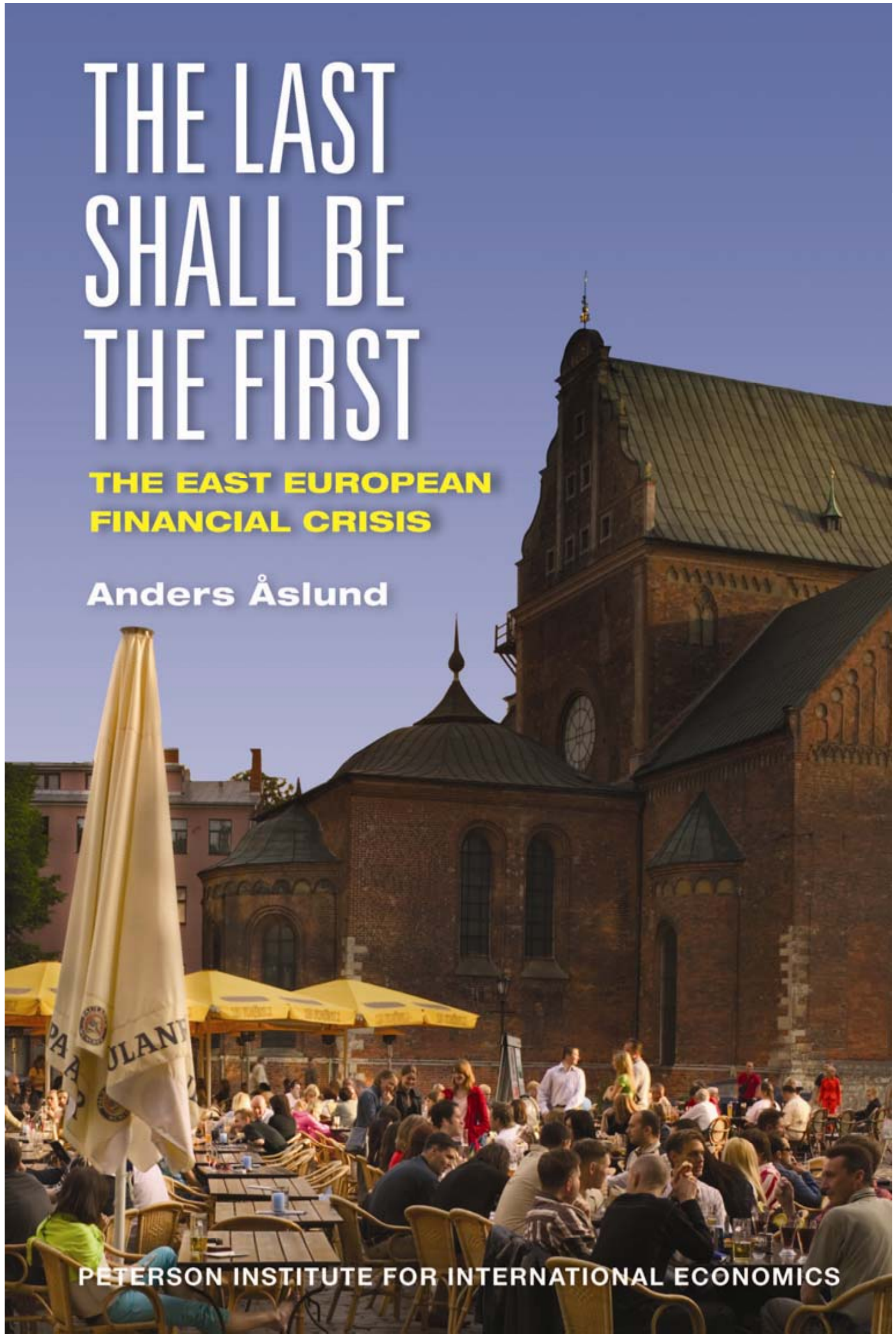

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