

Economic Governance in the Eurozone and the EU: Drawing lessons from the crisis

Cape Sounio, Athens, Greece, 10-13 June 2010¹

Session 1: How did Europe cope with the first phase of the crisis?

“NMSs: Hard Landing, But No Breakdown”

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The financial/economic crisis has taken a very heavy toll on New Member States (NMSs)², even though their banking sectors' exposure to toxic financial products was quite insignificant. While the impact of the crisis correlates with the size of pre-crisis imbalances NMSs have been, in general, worst hit among clusters of emerging economies around the world. From having, on average, highest overall growth rates in the EU their economies went into a tailspin once the crisis knocked them. Latvia epitomizes this plight: from scoring the highest economic growth rate in pre-crisis-years its GDP went down by a stunning -18% in 2009; Lithuania is second with a -15% drop of GDP last year (it is fair, however, to observe that Poland is the only EU country that avoided recession in 2009, though its budget deficit also rose sharply)³.

But a breakdown of some of these economies, as not a few analysts predicted, did not occur. Moreover, the radar screen has turned obsessively on the strains in the euro-zone and the sovereign debt crisis lately. Whereas in the fall of 2008 non euro-zone EU member countries were anxious to speed up their joining of the EMU (which was seen as a shelter) this demarche is viewed with ambivalence nowadays.

Transmission channels of shocks

There is a controversy between those who argue that trade was the main crisis transmitter and those who emphasize the financial route. Empirical evidence indicates

¹ With the support of the Lifelong Learning Programme, Jean Monnet Actions of the European Union Education, Audiovisual & Culture Executive Agency. This project has been funded with support from the European Commission. This publication reflects the views only of the author, and the Commission cannot be held responsible for any use which may be made of the information contained therein.

² The focus is on the ten post-communist countries, which joined the EU in 2004 and 2007

³ In 2009, the fall of GDP in other NMS was: -5% in Bulgaria; -14.1% in Estonia; -6.3% in Hungary; 7.1% in Romania; -4.7% in Slovakia; and -7.3% in Slovenia. For the euro-zone as a whole the fall of output was 4.1% in the same year. Outside the EU Ukraine's drop of output was very steep (-15%) in 2009 (source: IMF, World Economic Outlook)

that the financial channel has played a more significant role in propagating the shocks. The freeze of financial markets has severely impacted on the flow of funds toward economies whose growth relied on capital imports extensively. But to underestimate the influence of the trade channel would be a mistake⁴.

Why such a dramatic economic downturn?

Explanations relate to structural and macroeconomic conditions. Among structural circumstances one can range:

- deep financial integration and high foreign ownership of local banking sectors;
- heavy reliance on capital imports and pretty high expansion of foreign currency-denominated domestic credit (the Czech republic is an exception);
- monetary and exchange rate arrangements;
- the rules of the game in the EU --more specifically, the, arguably, premature total liberalization of the capital account, which defeated local authorities' attempts to stem the frantic pace of domestic credit.

In good times structural circumstances fuelled growth; in bad times, when and after the crisis erupted, these circumstances have revealed both pluses and pitfalls. For instance, deep financial integration has brought about the freeze of credit markets, like in the old EU member states. On the other hand, the assistance provided by home country governments to banking groups has, indirectly, helped local subsidiaries which operate in NMSs. Or, currency board arrangements favored price stability initially, but also a boom and bust dynamic by enticing massive capital inflows (which were attracted by high interest rate differentials (high yields) and exchange rate stability). In the Baltic countries, a painful correction of large imbalances was unavoidable; the crisis only made it worse.

Macro-conditions refer to unsustainable economic growth rates in overheated economies and macroeconomic imbalances:

- a steady appreciation of real exchange rates (which caused a sort of a Dutch disease in some NMSs);
- large external imbalances in several NMSs;
- the abnormal rises in property prices, which was triggered by foreign capital inflows - not in line with macroeconomic fundamentals, made the economic crash stronger via a negative wealth effect;
- though public debts are small in NMSs, some of these countries have been pursuing pro-cyclical fiscal policies in the years preceding the crisis and have misspent public resources.

But common features for NMSs cannot hide a major fault line: Central European economies (Slovakia, the Czech Republic, Poland, Slovenia and, partly, Hungary) evince significantly smaller structural imbalances than in the Baltic countries, Romania and Bulgaria; the former countries' trade balances show a considerably better integration in EU industrial production networks; their resource allocation

⁴ The global trade collapse - highest since the Great Depression has played a role in denting external demand sharply (NMS's are mainly suppliers of intermediate goods);

appears to have been substantially more favorable in terms of tradeables-orientation. *An analogy can be made between this fault line and the one in the euro-zone, between current account surplus and deficit countries. This fault line provides insights as to prospects for joining the EMU in the foreseeable future –in view of the lessons the current crisis teaches with respect to the functioning of the EMU.*

An inference can be made: structural factors and policies have interplayed in differentiating the performance of NMSs' economies both before and after the crisis hit.

From predicament of to avoidance of collapse

In the wake of Lehman Brothers' fall not a few analysts predicted the collapse of several NMSs because of their large current account deficits and bulging short-term external borrowing. Although most of this borrowing was made by private entities the systemic risks ensuing from a sudden stop of external funding were more than threatening. The worst case scenarios were, nonetheless, averted owing, inter alia, to:

- the relative soundness of banking sectors in NMSs (little direct exposure to toxic products), although the economic downturn has caused an important rise in NPLs;
- the indirect support the local banking sectors have got from the rescue package provided by home country governments to cross-border operating banks;
- the Vienna initiative, which, as a market coordination device, has brought together major stakeholders who are interested in preserving financial stability;
- the EU and IFIs supported adjustment programs in several NMSs (Hungary, Latvia, Romania) which have prevented liquidity crises turning into solvency crises;
- flexibility of IMF's policies, which learned from the Asian crisis of the past decade (it has accepted larger budget deficits and even their direct funding)
- the low level of public debts in most NMS (Hungary is the exception), which keeps, still, the debt service manageable;
- sharp reversal of current account balances; in some instances these have turned into major surpluses (the case of Baltic countries is striking⁵), though this is less the result of deliberately changed policy-mixes and is more due to a drastic cut of external funding, sharp falls in domestic investment and rises in domestic saving.

Issues of concern

Though the worst for NMSs may likely be over adjustment processes (fiscal consolidation, real exchange rate realignment) stay as huge challenges. Where imbalances are bigger and the monetary and exchange rate arrangements are more restrictive policy options are more limited. The small size of most NMSs' economies and their deep integration into EU markets make them highly dependent on the

⁵ Current account balance reversals are quite telling: in Estonia, from -9.4% to 4.6% of GDP; in Latvia, from -13% to 9.4% of GDP; in Lithuania, from -11.9% to 3.8%; in Hungary, from -7.2% to 0.4% of GDP (Source: IMF, World Economic Outlook).

fortune of the EU as a whole, of the EMU in particular⁶. Below are listed several issues of policy concern:

- the pace of economic recovery in the EU (since weak recovery hampers growth prospects in the NMSs); the deflationary impact of fiscal adjustment policies in EMU member states
- though NMSs' public debts (except in Hungary), as a share of GDP, are quite low the leeway for pursuing counter-cyclical policies is sharply limited by the looming fiscal crisis in the EU and elsewhere. Markets pay increasing attention to the size of budget deficits (not only to the level of public debts). If the economic downturn involves a permanent a loss of output the size of deficits would matter increasingly;
- the crowding effect on international credit markets;
- mitigating the pains of adjusting real exchange rates in the Baltic countries should consider exiting the currency board arrangement. But this option depends on burden-sharing arrangements among stake-holders;
- if NMSs could use the EU funds to the utmost the deflationary impact of austerity measures would be counteracted to a large extent;. can the EU (the Economic Commission) help more to this end?
- the state of the banking industry: as more losses are revealed the longer deleveraging will likely be and, therefore, the more discouraging prospects for credit resumption in NMSs are (the ECB says that additional write-offs of up to 200 billion euro are to be expected on European banks' balance-sheets)
- dealing with burden-sharing (in the case of a distressed bank) when local banking sectors are dominated by foreign banks –resolution schemes;
- benefiting on ECB's facilities which alleviate liquidity problems (swap lines between the ECB and central banks; a broadening of ECB range of collaterals to national currency denominated bonds issued by non-euro NMSs);
- the reform of the functioning of the EMU (among others: would means be found to offset the deflationary effects of the adjustment policies which are/will be undertaken in a rising number of EMU countries?)
- extend measures aimed at protecting EMU member states against speculative attacks to NMSs which do not belong to the euro-zone;
- once in the EMU, adjustments can be made through wage reductions/controls. Is any NMS ready to join EMU soon in view of competitive pressures?
- the reform of the regulation and supervision of financial markets: for the sake of fostering trade and economic growth the inherent volatility of financial markets has to be reined in! The EC should not succumb to the pressure of vested interests and promote bold reforms, both in the EU and in the G20. The restriction on naked short selling is not inappropriate

The bottom line: how to foster resilience and self-reliance in an environment which presumes deep integration of financial, trade, and labor markets remains a huge challenge.

⁶ The EMU, as a symbol of deep financial integration, is undergoing a crisis because of inadequate institutional and policy underpinnings.