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The nature of economic crises – An introduction

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Causes and initial policy reactions

After banking and currency crises of regional nature in the 1980s, transition recessions and banking collapses after 1990 in former planned economies, deep currency depreciations and banking crises in some fast growing emerging economies in the 1990s, asset price explosions and implosion in stock exchanges in some developed economies, now the world economy experienced again a full fledged financial crisis. The turbulences on the international financial markets, starting in 2007, gradually evolved into recession, the most synchronized one since the Great Depression of 1929-1933. No open, trade dependent country could remain safe from the general malaise. But, interestingly, not all suffered in the same way and to the same degree. Three years after, hard data indicate that the economic consequences of the crisis have proved to be rather different by countries and continents (IMF, 2010; BIS 2010, European Economy, 2009).

Since the burst of the American “sub-prime” bubble in the spring of 2007, a lot has been written about the causes and drivers of the financial problems that first appeared in the ‘core of the core’, that is, in the developed market economies. In the age a globalized finance it comes as no surprise that the malaise spread soon to the periphery of the globe. Still, it is important to note that the USA and the Euro zone countries were hit first; previous financial turbulences tended to surface in emerging, transforming and developing countries. In a contrast, this time major developing (“emerging”) economies, such as India and China, did not suffer much from the direct effects of the storm in financial centers.

If core economies were the first to take a hit, they were also the first to recover from recession lasting one and a half year. Compared to earlier crises, this one turned out to be very different; milder as far as loss of jobs and social tensions are concerned than in all earlier crises cases. Before congratulating to policy makers and business leaders, one has to add immediately: governments built a huge pile of sovereign debt during this relatively short period. Obviously this was the price of saving the economies from an old fashioned Depression. History did not repeat itself: the recent crisis may have been nearly as deep in terms of contraction of industrial production as the Great Depression of the 1930s but this time personal consumption in the developed economies only slightly decreased during the crisis, and unemployment remained moderate (Bordo & Landon-Lane, 2010).

At the same time, in the emerging economies of Europe (EEE) the recession turned out to be steeper. Economic openness, until now an unquestioned tenet of any good economic and social policy, seems to have contributed to the deeper than expected contraction. In 2008, foreign investors suddenly lost faith in these markets, once regarded as a safe bet and a higher than normal yield investment target. When fund holders and investors defected in near-panic, national currencies depreciated, stock markets fell, foreign trade shrank, and with them also GDP and living standards (Bod, 2009).

This is why in this part of the world it is not enough to scrutinize the general causes that led to the global turmoil: for analysts and decision makers of EEE it is essential to gather the lessons one can already learn about particular policy mistakes and/or structural factors, keeping one's eye on the future. The story of the crisis in the region of EEE is not a closed chapter. The recession may be officially over but forecasts, as L. *Csaba* put it, no longer count with a "return to normalcy", i. e. an annual 4 to 5 per cent GDP growth in Central and Eastern Europe; and generally speaking, there will be no return to 'status quo ante' (Csaba, 2009).

Not that even core economies could simply leave the recent turbulances behind. Most high level analyses by the IMF, BIS, OECD, central banks, and think tanks have so far aimed at decomposing the crisis and looking for institutional guaranties of avoiding a similar one in the years to come; the main concern obviously being the health and integrity of the international financial system. The system works again, and initiatives have been launched within internatioanal bodies to strengthen the capital base of structurally sensitive financial institutions, and to make national financial supervisions work better.

At the time of writing this piece, the financial system does seem to work. This is a simple statement, but an achievement against the background of similar financial crises, according to the research of *C. Reinhart* and *K. Rogoff* (Reinhart and Rogoff, 2009b). In their large international historical sample, asset market collapses prove to be deep and prolonged: equity price collapses average 55 percent over a downturn of about three and a half years. Second, the aftermath of banking crises is associated with deep declines in output and employment: the unemployment rate rises an average of 7 percentage points over the down phase of the cycle, which lasts on average over four years. Output falls (from peak to trough) an average of over 9 percent, although the duration of the downturn, averaging roughly two years, is considerably shorter than for unemployment. Third, the claim, the real value of government debt tends to explode, rising an average of 86 percent in the major post–World War II crisis episodes. They add that, interestingly, the main cause of sovereign debt explosions is not the widely cited costs of bailing out and recapitalizing the banking system; the big drivers of debt increases are the inevitable collapse in tax revenues that governments suffer in the wake of deep and prolonged output contractions, as well as often ambitious countercyclical fiscal policies aimed at mitigating the downturn.

Compared to the historical sample, the financial and economic crisis of 2007-2009 offers striking differences and some similarities. Recovery of the financial system has been pretty fast – suspiciously fast, you may add. The newly regained working mode of the global finance came at a high price for the advanced economies. As a consequence of the massive fiscal stimuli in 2009, sovereign debt overhang has become, not surprisingly, the major economic problem. As *J-C.Triche*t, president of the European Central Bank has summarized, the current debt problems in advanced economies are the results of a long gestation over the past few decades, originating in the financial deregulation and innovation of the 1980s and 1990s (Trichet, 2010). During this „golden period" new financial products emerged, which changed the economic behaviour of households and businesses. Modern finance promised to be a broad welfare-enhancer: families could smooth their spending over time more easily, mortgage finance became available also for the segments of the population previously excluded from the market. All these promises ended in bitter disappointment about markets, financial finess, enhancing social policies – and uncontroversial economics.

Now it is high time to rethink former certainties in economics and finance; as for taxpayers, it is time to start repaying the accumulated public debt.

On economics, economists and economic policies

It is worthwile to pause a bit on the received wisdom and professional certainties of the economic profession. When the regimes changed in former planned economics in early 1990s, a vision of market economy (capitalism) that can look after itself had its golden era. „End of history", faith in markets that will solve all posssible problems, suspicion on what a state may do in economy – this was the mainstream.

The privatization and liberalization processes went ahead full steam both in rich economies and in transition countries, supported by the economics mainstream. The benefits of financial deregulation and capital market innovation (such as securitization and structured products) appeared to be underpinned in the West by exceptionally benign conditions for doing business. The macroeconomic environment in major markets (Japan being an exception) was conducive to growth and wealth generation, and all this seemed firmly underpinned by improved economic policy making and deep knowledge on the economy. This „near-nirvana" environment became known as the "Great Moderation" through the statements of, among others, *B. Bernanke*, a former Princeton professor (Bernanke, 2004). One can quote also other influential authors such as economics Nobel-laureate *R. Lucas*, of the University of Chicago, about whom *Paul Krugman* does not fail to mention how Lucas declared the „macroeconomics in this original sense has succeeded: Its central problem of depression-prevention has been solved, for all practical purposes, and has in fact been solved for many decades." (Lucas, 2003) (Krugman, 2009).

It is certainly thought-provoking the recall how not long ago politicians, central bankers and influencial economists declared a battle successfully won against inflation and damaging macroeconomic volatility. The promise was, and seemed to be delivered for a long period, to prevent serious instabilities within the globalised financial system. A battle maybe won, but not the war. The "Great Moderation" era has produced a

number of damaging by-products. Financial innovations and liberalised capital markets, in combination with globally low real interest rates, led to the accumulation of enormous credit-creation potential, fortering a rapid rise in asset prices which ultimately led to global excesses and imbalances.

2007 and what came after that washed away the self-assurance of the economics profession. Politicians of developed countries were also forced to rethink the realities in terms of relative market power; see the emerging role of G20 replacing former groupings and power formulae. Imbalances this time did not erupt first and foremost in the periphery of the world economy, unlike many currency and banking crises of the last half a century. This is certainly a new situation compared to recent history which saw less developed countries become (sinless or sinful) victims to external crisis, as in the case of some Latin American countries in the 1980s, east Asean economies in the 1990s, Russia in 1998. This time it is Britain and the USA that ran a two-digit public sector deficit in 2009 – magnitude of fiscal imbalance previously known only in badly run developing counties.

Well, the lessons from the previous Great Crash have been learnt. That depression followed a speculative boom (of the 1920s), a manifestation of overinvestment, but at that time the policy prescriptions included tight money, tight fiscal policy and wage cuts to restore balance. It was *Keynes* (1936) and followers who rejected the then mainstream (the „Classics") that had claimed that eventually a return to full employment would be achieved by wages cuts and falling prices. Keynes attributed the slump to a collapse of aggregate demand, especially of private investment, thus his policy prescription was to use fiscal policy—both pump priming and massive government expenditures. It worked. In the post World War II era, Keynesian views dominated the economics profession, and politicians embraced the new mainstream. (Bordo & Landon-Lane, 2010)

There is something curious about the instant return to Keynesianism in recent years. Once the mainstreat, then fading away as new schools of economic thinking took its place since the 1970s, Keynesianism is back in economic policy practice of developed nations - without much explanations and debates. True, as *Csaba* notes, Keynesianism may have been by and large discarded in mainstream academic departments, but it has never lost its appeal entirely for policy makers; it is enough to mention the Stability and Growth Pact of the EU, expecting public sector surpluses in good times but deficit spending at bad times, along the original Keynesian principles (Csaba, 2009).

Most governments in and out of the EU have, however, tended to apply these principles in an asymmetric fashion: engaging in massive spending in crisis without making savings at good times. Still, the US and the EU, and in fact most of nations of G-20 acted in Keynesian fashion, and central banks also applied their measures of monetary easing. It seems to work: the depression a la 1930s has been so far avoided.

About the price tag: public sector deficit data in 2009 are hard to believe, particularly for someone not raised in an othodox Keynesian mould: large government deficits in percentage of GDP were recorded by Ireland (-14.3%), Greece (-13.6%) the United Kingdom (-11.5%), Spain (-11.2%), Portugal (-9.4%), Latvia (-9.0%), Lithuania (-8.9%), Romania (-8.3%), France (-7.5%) and Poland (-7.1%) (Eurostat, 2010). The consequences of such massive deficit spendings cannot be avoided even if developed countries claim easy access to financial markets at relatively favourable conditions. But it would be an overgeneralization to declare that rich countries can simply afford to spend more public money than they actually have in their coffers. True, financial markets not long ago did not seem to bother about EU member states' creditworthiness, believing that European countries could not go bust. But the Greek sovereign debt scare in early 2010 reveals that market players are learning to differenciate among customers. It is enough to recall that in the autumn of 2010, the yields of ten-year bonds issued, say, by Ireland and Portugal were as high as 6 per cent, while Italy's yield being below 4 per cent, Germany's less than 3 per cent a year – all that mean that investors can tell good European county risks from less good.

Surprise crisis cases – begging for explanation

Financial crises and sovereign defaults have been until recently mostly associated with developing nations or emerging markets. Interestingly enough, defaults on external debts have been far more concentrated in emerging markets than banking crises have been but, as historical research reveals, sovereign defaults on external debt have been quite common for countries maturing from an emerging market status in their ascent to an advanced economy class (Reinhardt and Rogoff, 2009a).

This recent crisis has been uncharacteristic in that rather developed or otherwise well-placed economies have suffered shocking output decline or have experienced near-defaults shocks. The European chapter of the story of financial turbulences opened with Iceland, a rather rich island, and Hungary, a member state of the European Union (EU) since May 2004. These were the first two European countries in three decades to turn to the International Monetary Fund for funds to avoid financial collapse in late 2008, soon followed by Latvia, a Baltic state, and then the Ukraine, not a member of the EU.

The banking and financial crisis of Iceland could be regarded an accident, or a sad but understandable consequence of bankers' over-lending and shocking policy mistakes: see the outspoken analysis of the case (Gylfason et al. 2010). The authors make it clear that authorities of small countries in crisis cannot be entirely absolved from responsibility: not all shocks were external in origin, and domestic institutions and policies have their own proper role in managing the aftermath of shocks. „Some of the extreme cases, such as Ireland and Iceland, had predominantly homemade crises that were only ignited by the global developments. They had for years been pursing lax or expansionary policies and did far too little to ensure adequate regulation and supervision of their financial systems. In retrospect it is clear (and, according to many observers, not only in retrospect) that these countries allowed credit expansion to proceed and a real estate bubble to build up in an unsustainable fashion" (Gylfason, 2010).

Compared to the Icelandic story, the Hungarian case looks more puzzling and thought provoking in the whole context of global financial order. Here the economy was not overheated before the events, and there was no real estate bubble. The Hungarian economy is closely connected with other old and new member states of the EU, and as a member, the country is a party to a number of policy institutions of the EU geared to coordinate, control and harmonize national economic policies. True, economic policy had been faulty for years before the crisis hit Europe – but this explanation for the process that led to sad outcome invites a question: how come that membership in the EU does not save a member state from developing serious imbalances that may trigger speculative attacks on the currency?

Now, the problems with Greece make it obvious that the Stability and Growth Pact, the Maastricht criteria of entry into eurozone, and similar institutions do not work efficient enough to fend off serious domestic policy failures within the EU. In the Hungarian case, massive government overspending between 2002 and 2006, worsening sovereign risk rating, too little genuine reform for a long time – all reduced the country's ability to withstand external shocks: disruption of cross-border financial flows, increased currency volatility, shrinking foreign markets. National policies matter; they matter more in turbulent times than in good weather.

What then should be done?

But this is past history. Academic and applied policy research must offer reliable answers to the obvious question: what should be done now, having survived the recent shocks and turbulances in Europe? In what follows, the author outlines a number of key policy issues already on research agenda, adding his own tentative answers, admittedly from the EEE viewpoint.

First, should we turn our back on financial globalization? One of the consequences of earlier sweeping trade and financial liberalization and fast privatization during the regime change process was the deep penetration of foreign capital, and in particular foreign financial institutions into former planned economies. Their entry undoubtedly raised the level of sophistication in finance, and opened up channels for funds that would not had come to the region otherwise. Yet, in the period of global credit crunch, this success story revealed its flip side: the region's economy became excessively dependent on foreign capital and foreign markets.

The previous wisdom was that foreign banks guaranteed high professional standards and abundant liquidity in hard currencies – key ingredients for economic growth and support to entrepreneurship After the crisis, it is less convincing that such a dependence on foreign banks with their headquarters abroad is riskfree for the host nations. A well functioning financial system is a crucial factor in the recovery of the central, eastern and southern part of Europe – there is no question about is. But the interfaces among banks (mostly owned by distant global players), enterprises (foreign and domestic), and governments have proved to be fuzzy and suboptimal. Thus the first tentative conclusion is that a more balanced relationship is required among players and stakeholders of the financial intermediation in transition and emerging economies.

Second, is it time to return to some market protectionism, on a „patriotic economy policy" platform? The initial reaction of many politicians was to protect domestic jobs by reversing oursourcing – remember *M. Sarkozy*'s vow to bring back French carmaking jobs from Slovenia and other lower cost member states. In fact, not much of such thing has happaned – fortunately. With Europe under competitive pressure, it is vital for businesses to combine factors of production in a rational manner – which may mean integrating low cost human skills and geographical advantages offered by eastern, center and southern Europe. The new Mercedes assembly plant or the enlargement of the existing Audi motor engine plant in Hungary are the most recent cases to indicate the continuation of the oursourcing trend. Trade is vital for transition and emerging economies; any fallback into protectionism in the world would kill the prospects of nominal and real convergence to 'core' Europe. But in their present conditions, domestic businesses in EEE should be strenghened through further support to medium and small firms. Without a vibrant domestic economy (and a healthy middle class) open economies are too much dependent on occasional external factors, and themselves cannot much contribute to pan-European competitiveness.

Third, will the EU lose its significance in global economy policy coordination? Shall non-core member states look for some new direction, under newer configuration (Group of 20)? Based on recent forecasts and market analyses, one can venture to say that most of the European economy seem to have recovered from the shocks of 2008/2009, although the public sector debt is a long term challenge for the continent. And for the euro, the common European currency, as a matter of fact. Let us still hope that the recent crisis elicited the realization of the need for more institutional flexibility and dynamism in Europe. Hardly would G20 or other international forum make the EU institutions superfluous in policy coordinationa and regulatory harmonization for trade dependent European states, already in the EU or outside it. Long term market forecasts, however, indicate that the relative share of Europe in world trade and finance keeps shrinking, and so might shrink the bargaining power of the continent. In view of market trends, new and old members alike should attempt to diversify their product markets and financial clients to reduce dependence on a few not-too-dynamic markets.

In short: government circles and intellectuals in emerging economies of Europe cannot spare the efforts to rethink their nations' relative positions in fast changing global markets and the socio-economic policies that can help them remain in game for catch-up to more developed, established neighbours. The recent crisis has been rather particular among the large number of similar cases; policy answers to this present case may also be particular and innovative.

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