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The impact of the financial crisis on (South) Eastern European
countries - and the main lessons for the future

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1. Lessons from history and from shortcomings in the current crisis

First of all, I would like to thank the arrangers of the Economic Forum for the invitation to this wonderful environment in the Polish mountains. Being here and coming together with many top representatives from politics, central banks, academia and the corporate sector in Central, South Eastern and Eastern Europe makes actually the unofficial name of this conference – “the Davos meeting of Eastern Europe”- quite appropriate.

According to my own experience, decision-makers in considerable parts of the banking sector have – on average - lost professional skills in economic history in the past decade or so. Or – even worse - they did not care about economic history in times of affluence, excess liquidity (M growth) and exploding credits, exaggerated focus on quarterly profits and irresponsible bonus payments. The number of genuine bankers with broad banking knowledge seems to have decreased significantly. It has become harder to find “real” bankers on the executive floors in Western Europe and the U.S. This could be also a hint to the many relatively new (European) market economies.

Literature has given us a great number of contributions to the importance of well-working or well-developing financial markets on macroeconomic growth – from Raymond Goldsmith in the late 1960s to Andrei Shleifer and Ross Levine more recently.

In reality, more or less the whole globe gradually became aware of what a major financial crisis can mean to the real economy. In 2008, a severe global recession became unavoidable. Such a bad development was simply not on the cards two and a half years ago when the first signs of more concrete troubles in the American financial sector became visible. Despite the fact that most of us then understood that global financial markets had become much more integrated in the past decades, there were only a few experts like Nouriel Roubini and James Hamilton who at least roughly foresaw the degree of global contagion in the real economy.

There have been enough financial crises in the past that were caused by excesses in money supply and credit growth. I still wonder why bank executives have such short memories. In Sweden, we had a severe banking crisis in the early 1990s. Only a few years later, the world was confronted with the dot.com crisis and the so-called Asian crisis which had its starting point in two countries with very high current account deficits - Thailand and Malaysia - before a broader Asian contagion was noted. And when that crisis more or less had passed by, American and Swedish financial officers “prepared” for other bubbles, i. e. what was to become the subprime bubble in the U.S. on one side and the credit bubble in the Baltic states on the other side. Bounded rationality – using the great Nobel prize winner Herbert Simon’s words – must have penetrated the minds of many executives at some point as well. And the big current account deficits in parts of Asia from the latter part of the 1990s were forgotten already 10 years later when the rapidly expanding trade deficits in some European (reforming) countries started to skyrocket.

I tend to reject the opinion that economic theory and research did not give warning signals for preventing the current global financial crisis. Sure, we still do not have a comprehensive theory for global financial markets, and we still do not know how to model or calculate global multiplier effects from certain financial events or trends. However, a couple of hints – though from different angles - on a forthcoming major financial crisis could be found already around 2004/2005, for example, from

- *economic history*: (Charles Kindleberger, John K. Galbraith, Ben Bernanke, etc.)
- *psychology / behavioral finance* (Robert Shiller; herd mentality, overconfidence, etc.)
- *institutional economics*: (Douglass North, Oliver Williamson, etc)

- *incentives:* (Bo Holmström, Jean Tirole, etc.)
- *liquidity(M) , micro/ macro* (Jean Tirole, Axel Leijonhufvud, Allan Meltzer, Otmar Issing)

However, some research areas were highly underdeveloped before the financial meltdown in 2007 – and still are - such as

- *modeling bounded rationality (psychology)*
- *behavior and skills of financial managers and investors*
- *links between global financial markets and global macroeconomics*
- *research concerning the multiplier mp of the monetary base b ($M=mp \times b$)*
- *systemic financial risks*
- *global contagion (modeling global multiplier effects)*
- *links between financial products (micro) and their aggregated markets/ volumes (macro).*

In order to find remedies for avoiding future bursting bubbles, one has to look at the background of the still ongoing global financial and economic crisis. Knowing more about this, may be beneficial at some future point for countries in Eastern and South Eastern Europe. The following summary does not cover every single reason for the current financial and growth disaster. But the list below should be long enough to make understand that there were many factors behind the first big global financial explosion – and which should be regularly be checked in the future.

Reasons for the ongoing global and financial crisis (without ranking):

<u>Failures / shortcomings</u>	<u>Institutions for improvement</u>
Monetary policy (too low rates for too long time)	Central banks
Asset prices and monetary policy (missing link)	Central banks
Liquidity (too high, yield hunger, increasing risk)	Central banks, <i>banks</i>
Modeling (global aggregates/multipliers, etc)	Central banks, research
Co-operation central bank/supervision (insufficient)	Central banks, supervision
Capital reserves in banks (insufficient)	Supervision (X)*, BIS
Banks' capital requirements (procyclical)	Supervision (X), BIS
Risk leverage in banks' activities (too high)	Supervision (X), <i>banks</i>
SIV (mismatched balance sheets, capital shortage)	Supervision (X), <i>banks</i>
Incentives for granting credits (too little risk-oriented)	Supervision (X), <i>banks</i>
Cross-border supervision (totally insufficient)	Supervision (X) / BIS (X)
Supervision itself (analysis methods, competence)	Supervision (X), government (X)
Resources to supervision (too limited financially, in skills)	Government
Rating agencies (weak models, dependence on banks)	Supervision (X)
Financial literacy (too weak, private households)	Supervision (X), <i>banks</i>
Financial literacy (too weak, bank officers/leaders)	Supervision (X), <i>banks</i>
Consumer protection	Supervision (X), law(X), <i>banks</i>
Greed of investors	Supervision (X?), <i>banks</i>
Banks' risk models (too static, insufficiently global)	Supervision (X), <i>banks</i>
Banks' bonuses (wrong incentives)	Law, supervision (X), <i>banks</i>
Financial products (too complicated, low transparency)	Supervision (?), <i>banks</i>
Research (too national, too much "homo oeconomicus")	Governments, <i>banks</i>

* (X) = improvements that can be achieved by regulation – if handled carefully.

Even a quick look at this list shows that there is quite a substantial number of areas that cannot be improved by the banks themselves. Only half of about 20 areas can be left to the banks themselves to find more sophisticated solutions. However, this conclusion does not guarantee that the banks will stick to such a commitment forever or even at all. In this context, I am easily reminded of some words coined by Wall Street's greatest guru ever – Henry Kaufman from Salomon Brothers - in the mid 1980s when he commented so briefly and sharply then on financial deregulation: “Some re-regulation will be unavoidable in the future”.

II. Responsibility and regulation

When looking at the reasons for the global financial crisis as mentioned above, five institutions with major responsibility for the still ongoing financial earthquake can be found. They are – without ranking -

- *central banks*
- *supervision*
- *governments*
- *rating agencies*
- *banks.*

In other words, there are further institutions and groups of interest that can be partly blamed for the expanding and bursting financial bubble, with the U.S. as the causal and geographic origin. Thus, harder regulation of banks, of other financial institutions and financial products cannot do the job alone to prevent the world from financial crises or to limit future damage. There is also a great need of changing behavior and governance. But how can bad financial behavior be addressed when we still know by far too little about how to explain, measure, model and combat all those major shortcomings on financial markets?

Obviously, experts agree worldwide these days that necessary regulation on deregulated financial markets proved to be insufficient or lagging. We should also conclude that many central banks in the beginning of this decade focused too much on meeting their inflation objectives / targets at the expense of money supply and credit growth. Again, I ask myself why so many financial leaders did not listen to criticism from experts, sometimes not even when warnings were coming from their own organization. I personally remember written and verbal warnings concerning the procyclicality of the Basel II-capital requirements and the insufficiencies of rating agencies by the professors and central bank leaders Charles Goodhart (previously Bank of England) and Hans-Helmut Kotz (Deutsche Bundesbank). Claudio Borio (BIS) has been concerned about rising asset prices for a long time. Some other professors such as Robert Shiller, Raghuram Rajam and James Hamilton also sent their early warnings to the general public – though from different research angles.

Unfortunately, too few influential people listened to them. We simply had – and still have - too much herd mentality on global financial markets, analysts included. This phenomenon cannot disappear or be diminished decisively by regulation. The issue is rather a better understanding of markets – which again underscores the importance of behavioral finance, deepened global financial research and information. I warmly recommend the countries being represented here to increase research, analysis and application of behavioral finance. Besides, some psychological conditions and reactions may vary in a number of countries.

Furthermore, certain financial areas cannot work without effective regulation. This takes us to another keyword – efficacy. Regulations must function well under all circumstances, even the most dramatic ones. I usually make a distinction between

- *necessary and well-working regulations*
- *necessary and improvable regulations*
- *unnecessary regulations.*

Altmeister Paul Samuelson’s definition is still the one I often apply. In his textbook *Economics* – more recently published together with Robert Nordhaus – Samuelson writes that “regulations consist of government rules or laws issued to control the prices, sales, or production decisions of firms”...(and there is) in addition a newer form of regulation, known as social regulation”.

Certain social regulations in the aftermath of this ongoing crisis should be implemented ambitiously in order to more consequently protect bank customers – both households and corporations – but also to better protect the banks themselves and their employees. The aspects of meaningful social regulations should not be overlooked. This is why I have been pleading for a long time so strongly for improved financial literacy which would be a good idea for countries in Central and (South) Eastern Europe as well. Improved financial literacy should be achieved mainly by regulation – but also by giving financial support to voluntary organizations - directly or indirectly - by tax reduction.

Financial literacy may serve as a good example of combining regulations and private initiative. Looking at my list of reasons for the current global financial crisis, takes us “easily” to the conclusion that most areas with regulatory problems already had their regulations before the eruption of the acute crisis – but that many of these existing regulations did not work properly and/or allowed for loopholes. In other words: Regulations must be efficient which is not always easy to recognize during their design or preparation.

What we need are not only stress tests for banks but also for regulations. This assumes, however, much better macroprudential research, better models and practical application. Even extreme scenarios should not be ruled out. Apparently, the development of the current crisis must be considered as such a very unique event.

However, some obvious major **risks** in this current regulation cycle should not be neglected, such as

- *too strong general belief in regulation*
- *the risk of overregulation*
- *the risk of insufficiently functioning financial markets*
- *lagging efficiency*
- *overlooked future loopholes and shortcomings.*

To summarize: Certain regulations are without doubt unavoidable on globalized financial markets. This assumes improved institutions. Or as Dani Rodrik puts it: “The market economy is necessarily embedded in a set of nonmarket institutions”. This means that certain public intervention sometimes must happen in a market economy for special protective measures.

III. Experience from Sweden – and important conclusions in a Central and (South)Eastern European financial market perspective

The objective of this brief presentation is not to criticize some Central and Eastern European countries for more or less severe accidents in their own financial system. Sweden has also had two major financial crises in the past two decades, one in the early 1990s and another one at the present time, at least within some major institutions that have been expanding too rapidly in the Baltic states. Thus, there is good reason to be humble.

Let me sum up some of the policy and strategic mistakes that – in my opinion - strongly contributed to the two above-mentioned Swedish financial crises.

Major policy and strategy mistakes as early contributors to two Swedish financial crises

The crisis in the early 1990s:

Central bank:

- Unilateral link of the crown to the ECU/Deutschmark
- Too high “expansion generosity” for the banks by the administration after financial deregulation

Government:

Too high budget deficit, foreign debt and deficits in the current account

The (partial) crisis in 2008 - ?

Central bank:

Focusing too much on meeting the inflation target – which easily was met – and neglecting expansion in credit growth, asset price expansion and some Swedish banks’ credit risk exposure in the Baltic states.

Supervision:

Underestimating the risks in the Baltic states.

Government:

No major policy mistakes (strong public finance, macroeconomic balance).

Conclusion:

Macroeconomic balance makes countries more resilient to financial crises, even in mature economies. When it comes to (somewhat) less mature or emerging economies, this conclusion can particularly be related to healthy fundamentals for public finance and the balance on current account. The Swedish example gives good evidence for this conclusion.

Without good macroeconomic fundamentals, a fixed exchange rate in a less mature country usually cannot give a good protection against major financial imbalances. Pressure on GDP growth can become too hard.

Of course, it would be great to welcome further new EMU members. This should, however, happen from an absolute position of domestic strength in the applying country. Again: Fixed exchange rates in an unstable or poor economic environment usually lead to bad results when major financial crises occur.

IV. Conclusions

- Even if the U.S. may be seen as the starting point for the eruption of the global financial and economic crisis, it should not be overlooked that many countries had made their own policy mistakes that aggravated the consequences of that global economic disaster. Professor Otmar Issing – probably the main architect of the ECB – often said, and still does, that “stability always begins at home”. This may concern a whole nation, but also single companies and private households.
- Some parts of (South) Eastern Europe have been hit quite hard by the global financial crisis. Good and stable macroeconomic conditions, however, make the impact from such a negative exogenous development (somewhat) less painful and should open a more speedy road to recovery compared to imbalanced countries that have been hit sharply by shrinking confidence of (long-term) foreign and also domestic investors. Good general conditions and favorable microeconomic and macroeconomic equilibria may help considerably. This is one of the reasons, why the outlook for Poland – just to mention one country - after the crisis seems to look more favorable than for quite a number of other countries in the region.
- It is worth mentioning that international competitiveness will be very important for exports once the European/global economy starts to recover. Countries dealing with this issue now, will have a better chance to escape from the current problems than countries which in this respect are more passive. There is an obvious risk that the gap between the more ambitious and the more static countries will have widened after the crisis. Foreign investors will see (South) Eastern countries as much more heterogeneous markets than in the past.
- Generally speaking, the main impediments to well-working regulations and collaborative agreements come from human behavior (psychology). The current global financial and economic crisis can to a great extent be attributed to phenomena like greed, abuse of incentives, performance pressure (“angst”), overconfidence, neglect of historical experience, etc. Without improved research / interest for behavioral finance and understanding of this exciting scientific orientation, financial regulations will be continually limited in their efficiency. The “homo oeconomicus” has disappeared from global financial markets.
- Another important step forward is the recognition that regulations should be completely designed for giving the right incentives to players on financial markets. “Perverse incentive structures” – as Rajan calls one of the main characteristics of the current crisis – should not exist anymore in the future regulatory framework.
- The financial crisis has shown that there is good reason for reconsidering monetary policy at least somewhat, i.e. when it comes to the importance of variables like liquidity, credit growth and asset prices in certain booming situations.