Old and New Challenges in Emerging Europe*

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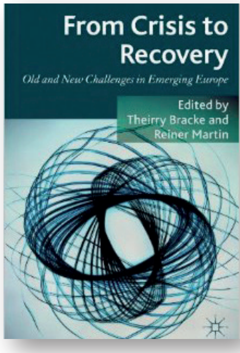
Ed by Thierry Bracke & Reiner Martin

From Crisis to Recovery: Old and New Challenges in Emerging Europe



Basingstoke: Palgrave Macmillan, 2012

ISBN: 9780230355286 HB; 240 pp.

The book was written based on the eponymous conference hosted by the European Central Bank (ECB) on 5-6 July 2011 in Frankfurt. The first two chapters cover the presentations held by Lorenzo Bini Smaghi and Jürgen Stark, both members of the ECB's Executive Board at the time. The subsequent chapters comprise the papers serving as the basis of the presentations held during the five sections of the conference, supplemented by a summary of the comments made at the event. The focus of the analyses were Europe's emerging countries, which suffered such a drastic decline during the 2008-2009 economic crisis that their performance still lags compared to other emerging regions of the world even after the crisis.

Examining the growth models of emerging European countries, the authors address the very relevant question of whether the European growth model of the years leading up to the crisis was unsustainable and whether it may have contributed to the worsening of the crisis, and also provide an overview of the main characteristics needed for a new, sound growth model fostering convergence with the developed world. Besides economic growth, the authors also address with great emphasis the integration of the financial system and many other financial stability issues. The rest of this article provides an overview of the

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main topics and findings of the papers comprising the book, partly in chronological and partly in logical order.

Coricelli[1] gives a positive assessment of the European integration model in the years leading up to the crisis, explaining that it fostered wage convergence between developed and less developed European countries. Bank loans played a predominant role in capital flows, and foreign ownership in the domestic banking sector. The institutional reforms linked to European integration fostered parallel foreign trade and financial integration, viewed by Coricelli as one of the cornerstones of sustainability.

The rapid growth during the upswing, however, was based on an unsustainable growth model. Dynamically growing domestic demand was the main driver of growth, fuelled by the inflow of foreign capital, abundant bank lending and rising asset prices. Smaghi highlights the fact that this did not go hand-in-hand with higher domestic supply resulting from productivity and capacity growth, even engendering internal and external real economic and financial imbalances. While expectations for future increases in incomes led to optimism, lower risk premia and excessive credit demand, low interest rates engendered excessive risk-taking and inordinate investment in non-tradable sectors (e.g. construction). The current account exhibited an increasingly large deficit in the majority of emerging countries, inflation accelerated and the labour market became tighter.

In the countries under review, the crisis was followed by deep recession, hitting countries with the largest current account deficits the hardest. Most of them were affected by the sudden stop effect, net capital inflow fell, as did export in the wake of the collapse of global trade. Drying up lending and the bursting of the property bubble dampened domestic demand. The crisis resulted in a substantial decline in government revenues and for higher budget deficits than in the past and compared to Asian and Latin American emerging countries. Coricelli explains that large net foreign debt was mainly accumulated in places where the speed of financial integration outstripped that of trade integration. The vulnerability of these countries to fluctuations in foreign investor sentiment stems not only from the size of the exposure, but also from sustainability issues linked to debt.

The chapter by Korniyenko[2], Ohnsorge[3], Ricka[4] and Zettelmeyer[5] gives an overview of the position of emerging European countries in finding their way out of the crisis. Although as a result of crisis management measures countries within the region started to return to a path of growth in 2010, albeit to different degrees, they still face substantial challenges

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2 Yegveniya Korniyenko is Economic Analyst in the Office of the Chief Economist at the European Bank for Reconstruction and Development (EBRD).

3 Franziska Ohnsorge is Senior Economist in the European Department of the International Monetary Fund.

4 Franto Ricka is Economist in the Office of the Chief Economist at the EBRD.

5 Jeromin Zettelmeyer is Deputy Chief Economist and Director of Research at the EBRD.

over the medium term. The region needs a new growth model, stable and sustainable in the long run, that builds on balanced foundations. Smaghi deems that it was primarily domestic political decisions that gave rise to the excess vulnerability of emerging countries. Economic convergence and European integration continue to be the main engine of economic growth. In the short run, productivity and export growth would be necessary, while in the long run – as a result of structural reforms – tradable sectors should be strengthened.

Mooslechner[6] and Reininger[7] conclude that relying partially on external funding is a natural part of countries' convergence. However, during the crisis, capital outflows most severely affected countries whose banking sectors featured large stocks of net foreign assets. Domestic deposit business lines should therefore be shored up. Developing the corporate bond market could support greater diversity to the funding of the real sector. The market for domestic bank bonds also needs to be reinforced in the majority of emerging countries. The inflation targeting system still provides an adequate framework for monetary policy, but macroprudential and supervisory regulation should be strengthened in parallel. The banking sector's resilience to shocks should also be bolstered and the development of domestic capital markets specifically supported. Coricelli calls for mitigation of the dual moral risk: while too-big-to-fail banks, counting on state guarantees, should be discouraged from excessively risky behaviour in the countries of their subsidiaries, locals in these countries should not count on foreign banks acting as lenders of last resort.

The book provides a comprehensive overview of the economic developments of the countries under review in the years leading up to the crisis, their different crisis management steps and the possible reasons behind the protracted recession. It also attempts to offer recommendations regarding the future, mainly relying on international comparisons and avoiding formal deductions. The analyses are supplemented by numerous charts and tables, making it pleasant for readers who are less versed in model based theories, but interested in economics and economic policy.

6 Peter Mooslechner is Director of the Economic Analysis and Research Department of the Oesterreichische Nationalbank (OeNB).

7 Thomas Reininger is Senior Expert in t he Foreign Research Division of the OeNB.