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

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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)
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

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