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Toward European Convergence

Remember that time is money.

—Benjamin Franklin, 1748

Listening to French President Nicolas Sarkozy at the St. Petersburg International Economic Forum on June 19, 2010, I was struck by how social democratic this purported center-right politician sounded. But otherwise his line had changed. Rather than talking about the eurozone of 16 as usual, he spoke of the European Union of 27. The fiscal crisis in the eurozone offered the broader European Union, including its new eastern members, a seat at the common table.

Many policy lessons can be drawn from the East European financial crisis. At the time of this writing, the whole region is undergoing economic recovery, although the financial situation remains constrained in Hungary and Romania. The current threat to recovery is not primarily internal but external: the fiscal crisis in the eurozone, which is depressing recovery in Eastern Europe.

The cause of the crisis in Eastern Europe, as in East Asia in 1997, was large current account deficits in the private sector that had accumulated into large private foreign debt. The crisis was connected with pegged exchange rates, which attracted vast capital flows into these countries, leading to excessive monetary expansion and overheating, thus making them vulnerable to global disturbances. In East Asia's recovery, the East Asian tiger model proved sturdy, and East European capitalism appears similarly strong. But the lessons of this shock must be remembered in both Eastern Europe and the European Union as a whole.

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Outcome of the Crisis in Eastern Europe

The most important outcome of the East European financial crisis was of course that the crisis was overcome fairly quickly. The main positive adjustment was a remarkably fast reduction of current account deficits, which swung to surpluses in the Baltic states, primarily because imports contracted more than exports. Central Europe achieved approximate balance, and Southeastern Europe reduced its deficits. International reserves rose in all the CEE-10 countries. In 2010, Latvia took only the cheap credits offered by the IMF and the European Commission but abstained from the more expensive bilateral emergency credits. Hungary even abstained from a couple of IMF disbursements. The exchange rates of Hungary and Romania recovered and stabilized. The remaining financial problems were large budget deficits and rising public debt, but only Hungary exceeded the Maastricht limit on government debt as before.

Inflation fell sharply so that all East European countries apart from Hungary and Romania now have less than 3 percent inflation. In spite of strains, the banking system survived with minimal losses at significant banks. No East European country was even close to sovereign default.

Carmen Reinhart and Kenneth Rogoff have argued that excessive leverage is always dangerous and that the form of indebtedness—private or public—does not matter much: "…sustained debt buildups (whether public, private or both) are important precursors to a financial crisis."[1] Yet, this point should not be taken too far. The real issue is to what extent the state will be forced to bail out the private sector, and the East European governments were quite successful in avoiding such compulsion. Apart from some recapitalization of state banks and subsidies to large state corporations, they minimized state aid, unlike Western Europe or the United States.

The most conspicuous negative outcome was substantial output declines, especially in the Baltic countries. Latvia saw a total decline in GDP of 25 percent, as the United States and Germany did during the Great Depression. Lithuania and Estonia were close behind with contractions of 17 and 18 percent, respectively, while the other countries had 4 to 8 percent of GDP decline, and Poland saw no reduction.

The other disturbing statistic is the rise in unemployment, which soared in four countries, the three Baltic countries and Slovakia. It seemed to have peaked in the first quarter of 2010 and then stabilized. Unemployment reached 20 percent in Latvia, 19 percent in Estonia, 17 percent in Lithuania, 15 percent in Slovakia, and 11 percent in Hungary. Yet, as a whole, unemployment has been less in Eastern Europe than in Western Europe. Slovenia, the Czech Republic, and Romania have had unemploy-

1. Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009), 217.

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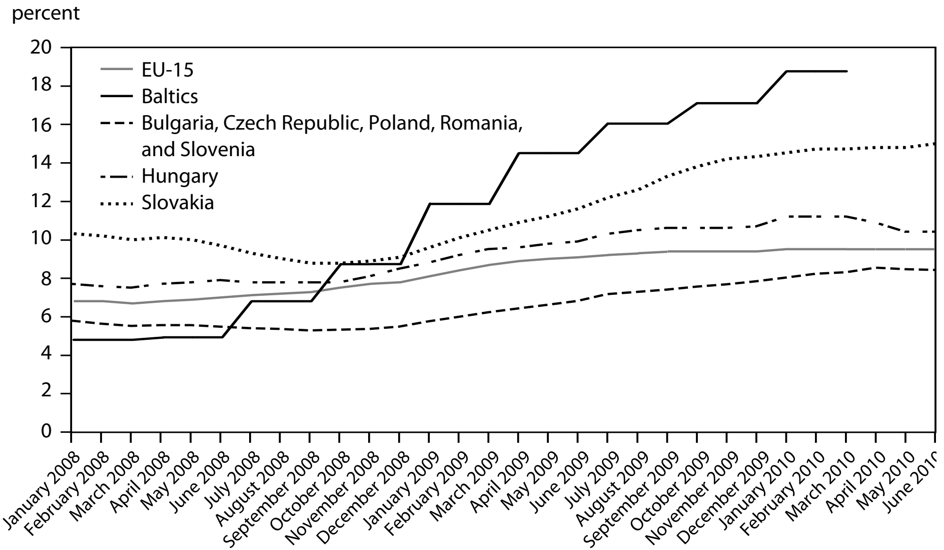
Figure 9.1 Unemployment rate, monthly average, January 2008–June 2010



PPP = purchasing power parity

Note: GDP per capita in PPP (constant 2005 international dollars) as a share of average EU-15 GDP per capita in PPP.

Source: Eurostat database, http://epp.eurostat.ec.europa.eu (accessed on August 9, 2010).

ment peaking in the range of 7 to 8 percent, below the EU average, which reached a high of 9.6 percent, while Bulgaria and Poland have been close to that average. These five countries contain the vast majority of the East European population (figure 9.1). In comparison with Western Europe, unemployment in the east has risen less than output has fallen. The explanation is that the East European countries have more flexible labor markets and the worst-hit countries have seen substantial cuts in both public and private wages.

Fiscal policy was relatively straightforward. With the exception of Hungary, which never undertook a standard postcommunist fiscal adjustment, all the East European EU members had adopted decent fiscal policies before the crisis.[2] The Maastricht criteria had more impact on countries outside the Economic and Monetary Union (EMU) that wanted to adopt the euro early than on those that are already privileged members of the club. This coincides with standard club theory: A club is more effective in imposing its norms on a candidate for entry than in policing itself.

2. Admittedly, in 1995 Finance Minister Lajos Bokros attempted a serious fiscal stabilization, but it did not last long.

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The European Union and the World Trade Organization are illustrative examples.

During the crisis, all CEE-10 countries in trouble cut public expenditures with great vigor. The three Baltic countries stood out: They slashed their budget deficits by 8 to 10 percent of GDP in 2009. These countries as well as others then forced structural changes, primarily in three neglected areas: public administration, health care, and education.

The tax systems in the whole region were already in good shape and were further improved with a broadening of tax bases as loopholes were eliminated. The low flat personal income taxes were maintained, as were the low corporate profit taxes, while value-added taxes and excise taxes were raised somewhat, and payroll taxes reduced. The big remaining reform in most countries concerns the pension system.

Constitutional rules have come to play a new, important role for economic policy during this crisis in two opposite ways. In Latvia and Romania, the constitutional courts refuted legislated reductions in pensions. As a consequence, pensioners have not shared the burden of austerity, and the share of pensions in GDP has risen sharply. Clearly, constitutions should not be allowed to block beneficial structural reforms, and if necessary such constitutions need to be amended. A new tendency is to limit public deficits or debts through the constitution. A recent amendment to the German constitution limits the budget deficit to 0.35 percent of GDP in 2016 and the Polish constitution restricts public debt to 55 percent of GDP. This new constitutional trend together with activist constitutional courts is likely to enhance austerity in the future.

The dominant role of 15 West European commercial banks in Eastern Europe greatly contributed to the development of the region's banking system before the financial crisis, but these banks were also the engines of the credit boom and overheating. Neither their domestic financial authorities nor East European bank supervision regulated them appropriately.[3] This observation raises the demand for pan-European regulation of multinational banks,[4] which the European Union is now acting on, with its establishment of the European Banking Authority and other bodies for supervision of insurance and security markets. Thus far, the West European banks have been reasonably helpful.

3. Bas B. Bakker and Anne-Marie Gulde, "The Credit Boom in the EU New Member States: Bad Luck or Bad Policies?" IMF Working Paper 10/130 (Washington: International Monetary Fund, 2010), 32; and a study of the regulation of Swedish banks in the Baltics showed that nobody felt responsible (personal communication with Swedish Member of Parliament and Professor Carl B. Hamilton on May 21, 2010).

4. Peter Zajc, "A Comparative Study of Bank Efficiency in Central and Eastern Europe: The Role of Foreign Ownership," *International Finance Review* 6 (2006): 117–56; Rainer Haselmann, "Strategies of Foreign Banks in Transition Economies," *Emerging Markets Review* 7, no. 4 (December 2006): 283–99.

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The East European crisis also marked new collaboration between international players, primarily the IMF and the European Commission. The IMF successfully returned to the original Washington Consensus with relatively few conditions: a reasonable budget balance and a realistic exchange rate policy, while focusing more on bank restructuring. It provided far more money than previously, heeding Jeffrey Sachs's advice from the early 1990s.[5] By financing not only currency reserves but also large budget deficits, it has taken over much of the traditional subsidiary role of the World Bank. Its eventual success, however, depends on the political judgment of its management and major shareholders. The European Commission found its place with surprising ease as a partner of the IMF, following and controlling it while providing large financing.

EU Convergence or Divergence?

The most disputed issue was exchange rate policy, but curiously, no country has changed exchange rate policy during the crisis. The non-EMU countries in the CEE-10 insist on either currency boards or inflation targeting. The four currency board countries (Estonia, Latvia, Lithuania, and Bulgaria) are much more eager to adopt the euro. Their credibility, however, took a serious hit in the midst of the crisis. They had attracted too large funds, leading to excessive current account deficits and inflation. When global liquidity froze capital flew out fast. Still, these countries had a stellar fiscal record and soon they enhanced the credibility of their currency boards by standing firm. They deserve the euro and their euro adoption should be facilitated, as the IMF has argued.[6]

Since Europe is likely to face a deflationary environment for the next couple of years, it will be easier for the countries with currency boards to comply with the convergence criteria and adopt the euro now than before the crisis. The old problem, especially for the countries with currency boards, was excessive inflation, which raised an insurmountable hurdle and could not have been defeated without changing the monetary regime. Now fiscal contraction and other deflationary pressures have taken care of inflation. The remaining issue is to contain excessive fiscal deficits, which governments can and intend to do, and the crisis is giving them the democratic mandate to do so.

In the midst of the crisis, Estonia had quietly insisted on adopting the euro. After noticing that Estonia fulfilled the criteria on price stability, budget balance, public debt, and exchange rate stability, the European

5. Jeffrey D. Sachs, "Why Russia Has Failed to Stabilize," in *Russian Economic Reform at Risk*, ed. Anders Åslund (London: Pinter, 1995), 53–64.

6. Stefan Wagstyl, "Central and Eastern EU Nations Should Adopt Euro, Says IMF," *Financial Times*, April 6, 2009.

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Commission concluded in its annual Convergence Report published on May 12, 2010, that "Estonia fulfils the conditions for the adoption of the euro."[7] On June 7, the eurozone's ministers of finance supported Estonia's application to adopt the euro, and the next day the ECOFIN Council agreed. On July 13, EU finance ministers made the final decision to keep the existing exchange rate to the euro. Estonia will introduce the euro on January 1, 2011. The governments of Bulgaria, Lithuania, and Latvia are determined to achieve a budget deficit of no more than 3 percent of GDP in 2012 in order to be allowed to adopt the euro in 2014. As Lithuanian Prime Minister Andrius Kubilius stated about the euro: "It's an instrument that will allow us to feel a little more safe in the global financial system."[8]

The countries with floating exchange rates are much less enthusiastic about adopting the euro. Their larger size also makes the euro adoption less urgent than for the small Baltic states. For them, the European Exchange Rate Mechanism (ERM II) exchange rate stability criterion requires that fluctuations be kept within the narrow band of +/–2.25 percent. An EMU candidate country can obtain permission from the European Commission and the ECB to revalue its central parity, as Slovakia did, but it cannot devalue.[9]

But the current ERM II rules make little sense. The European Union should consider a revision to offer a more sensible path to euro membership. First, the ERM II period of at least two years should be reduced, because it is destabilizing by encouraging too large capital inflows, as the experience of the Baltic countries has shown. The ERM II, with fixed exchange rates before euro adoption, is like telling a soldier in battle to walk slowly between the trenches to prove that he can withstand machine-gun fire. Second, at the very least a floor should be set for the inflation criterion to avoid the excessively harsh judgment the European Union passed on Lithuania's inflation in 2006 or demand deflation. As Zsolt Darvas and Jean Pisani-Ferry have argued, a minimum threshold for inflation for euro candidate countries should be set. A limit of 2 percent—the ECB inflation target—seems appropriate, while the current rules set it at 1 percent (that is, 1.5 percentage points above the average of the three lowest inflation rates among the 27 EU countries).[10] The various inflation-targeting central banks have either 2 or 3 percent inflation as their target, and under-

7. European Commission, "Convergence Report 2010," *European Economy* 3 (provisional edition, Brussels, 2010), 11–14.

8. Paul Hannon, "Why Lithuania Still Wants to Adopt the Euro," *Wall Street Journal Europe*, June 23, 2010.

9. I owe this point to Marek Dabrowski.

10. Zsolt Darvas and Jean Pisani-Ferry, "Avoiding a New European Divide," Bruegel Policy Brief no. 10 (Brussels: Bruegel, December 2008). Several countries currently have deflation.

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shooting would not be beneficial. Third, ERM II countries should be given ample access to credit swaps if need arises again.[11]

Only in recent years has inflation targeting worked well in Poland and the Czech Republic, and exchange rate volatility has been scary during the crisis. The fiscal softness of Hungary and Romania undermines the case for inflation targeting, though it was much purer in Poland and the Czech Republic. Jiri Jonas and Frederic Mishkin have pointed out: "Even after EU accession, inflation targeting can remain the main pillar of monetary strategy…."[12] It should be favored until an EU country can actually adopt the euro.

In this financial crisis, the euro proved credible both in countries that had adopted it officially (Slovenia and Slovakia) and unilaterally (Kosovo and Montenegro). Paradoxically, currency traders perceived the monetary regimes of Kosovo and Montenegro as more credible than those of the virtuous Baltic countries. The euro on its own has greater credibility than the ECB. So much for the ERM II! The conclusion is once again that the expansion of the EMU should be facilitated and the ERM II abridged.

Stephen Roach has succinctly summarized the causes of the East Asian crisis of 1997–98: "That crisis stemmed largely from Asia's vulnerability to the vicissitudes of international capital flows. Lacking in foreign exchange reserves, overly exposed to short-term external debt and with rigid currency pegs, the region stood little chance when the hot money started to flee."[13] A lesson for the EU countries outside the EMU is that they cannot rely on the ECB or the European Union but need to hold sufficient international reserves themselves.

No government should accept major currency mismatches, that is, large domestic loans in foreign currency, especially not to consumers, and they can be regulated away.[14] But in June 2010, an ordinary Polish citizen could obtain a euro mortgage fixed for 30 years for as little as 3 percent a year, while a zloty mortgage cost 6 percent a year.[15] Bank regulation

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11. Jean Pisani-Ferry and Adam S. Posen, eds., *The Euro at Ten: The Next Global Currency?* (Washington: Peterson Institute for International Economics, 2009), 13; Zsolt Darvas and György Szapáry, "Euro Area Enlargement and Euro Adoption Strategies," *European Economy*, Economic Papers 304 (Brussels: European Union, February 2008); Darvas and Pisani-Ferry, "Avoiding a New European Divide."

12. Jiri Jonas and Frederic S. Mishkin, "Inflation Targeting in Transition Economies: Experience and Prospects," in *The Inflation Targeting Debate*, eds. Ben S. Bernanke and Michael Woodford (Chicago: University of Chicago Press for the National Bureau of Economic Research, 2005): 410.

13. Stephen Roach, "The New Lesson for Resilient Asia," *Financial Times*, June 9, 2010.

14. Morris Goldstein and Philip Turner, *Controlling Currency Mismatches in Emerging Markets* (Washington: Institute for International Economics, 2004); Morris Goldstein, "Emerging-Market Financial Crises: Lessons and Prospects" (speech at the 2007 Annual Meeting, Institute of International Finance, Washington, October 20, 2007).

15. Personal communication with such a borrower in Warsaw on June 7, 2010.

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can mitigate this market distortion, but outright prohibition of foreign currency loans is unrealistic in a small open market economy.

The most controversial issues are connected with the ECB: its monetary policy, the expansion of the euro, and exchange rate policy before adoption of the euro. The ECB widened the divide between the EMU and neighboring countries through its generosity to the free-riding insiders and its stinginess to EU outsiders in the early stage of the crisis.[16] Especially disturbing is that the ECB did nothing to help the virtuous countries with currency boards. If the ECB had provided swap loans to the Baltic states, Poland, and the Czech Republic, by accepting government bonds denominated in local currencies of non-eurozone EU countries as collateral, as Darvas and Pisani-Ferry advocated, the Baltic financial crisis would in all probability have been contained.[17] Neither before, during, nor after the crisis did the ECB undertake any action to promote financial stability in the EU countries outside the EMU. Through its spectacular inaction, not recognizing any regional responsibility, the ECB has earned a black eye. The rest of the world has been left wondering about its competence to manage European monetary affairs. As Pisani-Ferry and Adam S. Posen write:

> …the euro did little to improve the crisis response of neighboring countries in Central and Eastern Europe…. Even if the formal mandates of the [ECB] and the Eurogroup…do not formally include it, broader stability in the region should be a major economic and political objective as well.[18]

Posen continues:

> The global financial crisis has if anything clearly displayed the geopolitical limitations on the euro's global role because the euro area authorities have failed to show leadership even as a regional anchor currency. A successful regional currency role for the euro would entail fulfilling responsibilities toward countries in the region that have adopted the euro as a monetary anchor or whose financial systems are partially euroized.[19]

Two big policy questions going forward are how and how fast to expand the euro. The crisis has proven the extreme danger of not having access to ECB liquidity. The risk of overheating due to free capital flows and excessive inflation in countries on the EU periphery remains, but

16. Darvas and Pisani-Ferry, "Avoiding a New European Divide."

17. Zsolt Darvas and Jean Pisani-Ferry, "Eastern European Currencies Need Help Now," *Wall Street Journal*, March 12, 2009.

18. Pisani-Ferry and Posen, eds., *The Euro at Ten: The Next Global Currency*, 5.

19. Adam S. Posen, "Geopolitical Limits of the Euro's Global Role," in *The Euro at Ten: The Next Global Currency?* eds. Jean Pisani-Ferry and Adam Posen (Washington: Peterson Institute for International Economics, 2009), 93.

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presumably it will be much smaller for the next decade because of the recent financial crisis, which will limit credit expansion for years to come as banks deleverage.

The logical conclusion of Eastern Europe's suffering from the excesses of the eurozone governments and the ECB's loose monetary policy is of course that they demand rights as EU members and co-owners of the ECB to control both fiscal policies of the eurozone countries and the monetary policy of the ECB. Their influence on EU financial policy will be reinforced as they will gain seats in the new EU-wide financial supervision agencies that are supposed to improve inter-European bank, insurance, and security-market inspection.

The Last Shall Be the First

The current European financial crisis is reminiscent of the so-called Foundation Crisis (*Gründerkrise*) in Germany in 1873 after the jubilation over German unification. In a similar fashion, most EMU countries abandoned agreed fiscal constraints and the ECB flooded Europe with ample credit that went into asset speculation, and a typical bust followed, as Margrit Grabas has argued.[20] Europe would hardly have been hit by such a severe financial crisis if the EMU had not been established, because the old Bundesbank would have insisted on its old strict monetary policy and other countries would have been forced to follow, but the exchange rate chaos of 1992 would probably have been repeated.

The German Foundation Crisis was followed by two decades of deleveraging and slower economic growth from 1874 to 1896.[21] Today, long-term deleveraging appears inevitable, and the question is to what extent it will be undertaken through budget cuts, inflation, debt restructuring, or debt-equity swaps. With less credit available, savings and bank deposits will probably rise, which should render the banking systems in Eastern Europe more stable. Presumably, the East European countries will also aim at keeping larger precautionary currency reserves in the future. These factors will contribute to financial stability, but growth is likely to be significantly lower for the next decade.

Few things are as beneficial for progress as a total and complete humiliation, which the recent European financial debacle has been. It is a good reason for Europeans to straighten their thinking. The first big

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20. Margrit Grabas, "Die Gründerkrise von 1873/79–Jähes Ende liberaler Blütenträume. Eine konjunkturhistorische Betrachtung vor dem Hintergrund der Globalisierungsrezession von 2008/2009," *Internationale Wissenschaftliche Vereinigung Weltwirtschaft und Weltpolitik (IWVWW)* nos. 182/183 (2009), 66–82.

21. Walt W. Rostow, *The World Economy: History and Prospect* (Austin: University of Texas Press, 1978).

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lesson from the East European crisis concerns exchange rate policy. The greatest surprise was that the worst-hit countries—Latvia, Lithuania, and Estonia—were not forced to devalue, contrary to the claims of a broad chorus of American economists. Instead, these three Baltic countries pursued what they called "internal devaluation." Their governments cut public wages by up to 35 percent, and the private sector followed suit. They slashed public expenditures and their cost levels became competitive, allowing them to turn their large current account deficits swiftly to substantial surpluses. Both inflation targeting and pegs remain viable exchange rate policies, and internal devaluation is likely to become the rule for EMU countries in financial hardship.

Second, the East European crisis offers clear insights into the political economy of crisis. When the going gets tough, politics become a pragmatic matter of solving vital problems, while rational expectations with tradeoffs between various social groups are no longer politically relevant. Instead of widely predicted social unrest, the East European public has accepted their hardship with minimal protests. After many years of high economic growth, people were prepared for some suffering. These states had recently become free and were ready to stand up for their nations, and they were used to crisis from the postcommunist transition. Most crisis countries changed governments during the crisis and some of them twice, and the new governments were generally more determined and competent in their crisis policies, showing that frequent government changes may be beneficial for crisis resolution. Eastern Europe's fragmented proportional parliaments did not hinder crisis resolution but on the contrary made it possible to swiftly change governments when the incumbents fell short. They do not need to wait for an ordinary presidential election to get a competent government. Frequent government changes have facilitated the selection of more able leaders, who promoted more resolute anticrisis policies. The most successful governments were coalition governments of several parties, running counter to frequent views among political scientists that political stability, strong parties, and a powerful executive are beneficial. Many complain about the lack of leadership in Europe, but Eastern Europe has many eminent leaders. The current Baltic prime ministers stand out. For leadership, the European Union would be well advised to look to the east.

Third, a new European fiscal retrenchment is being carried out on the basis of a new political economy of pragmatism and fiscal conservatism. The center-right has never been stronger in Eastern Europe. Conspicuously, no reaction against capitalism or globalization has been apparent. Nobody is talking about capital controls. East European citizens blamed corruption and irresponsibility at home for their misfortunes, which were often associated with former communists. The fiscal balance can be restored only through vigorous cuts in public expenditures. Therefore, the large government redistribution in Europe, which in particular Vito Tanzi

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has long exposed, is now being addressed and is likely to be reduced.[22] The lesson from the East European crisis is that it is politically possible to cut public expenditures, salaries, and employment, as well as rationalize health care and education. The big remaining task is pension reform. The tax reforms in Eastern Europe with low flat income taxes and similarly low corporate taxes are surviving. The Stability and Growth Pact is being reinforced, since people and politicians have recognized the depth of the fiscal crisis. The postcommunist crisis forced the East European economic systems to be leaner and more efficient. This crisis is likely to persuade the West Europeans to do the same. Europe is moving toward a more efficient economic model without forgetting social values.

Fourth, the IMF stands out as the great victor on the international stage. It revived the old Washington Consensus of a few rudimentary financial conditions, such as tenable exchange rate policy and reasonable fiscal and monetary policy, but it allowed the well-governed countries larger public deficits during the crisis and offered much more financing, also for budgets, than before with the understanding that this was a temporary current account crisis. It acted faster than usual. The European Commission entered into an astonishingly successful partnership with the IMF in Eastern Europe. It allowed the IMF to take the lead, while providing substantial financing, more than the IMF in the case of Latvia, and it checked the work of the IMF. When financial crisis hit the euro area, however, the European Union seemed to have forgotten all its fortuitous lessons from Eastern Europe, attempting to keep the IMF out. In the end, the European Union came to its senses and let the IMF take the lead also within the eurozone, which helped mitigate the crisis.

Fifth, the ECB has been the great disappointment in the East European financial crisis. Its single contribution was to expand its credit supply to salvage the European banking system in the fall of 2008, also saving their subsidiaries in Eastern Europe. Before the crisis, however, the ECB ignored financial stability and the massive overheating in some EU members both inside and outside the euro area. The entry conditions to the eurozone demand that a country peg its exchange rate to the euro for at least two years, but the ECB did nothing to stabilize the economies of these euro candidate countries. It could have offered swap credits to eastern EU economies outside the euro area, but it did not. Evidently, the ECB needs to reconsider its policies, especially outside the eurozone, and become more proactive.

In the end, this crisis is likely to benefit both Eastern and Western Europe and thus the European Union. Western Europe will have to learn from Eastern Europe, thus erasing the current division between first- and second-class members in the European Union. The East Euro-

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22. Vito Tanzi and Ludger Schuknecht, *Public Spending in the 20th Century* (Cambridge: Cambridge University Press, 2000).

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pean countries have persistently had much higher growth rates than the West European countries, and economic convergence between them in terms of GDP per capita has been impressive for the last 18 years. Thanks to the East Europeans, the West Europeans have slashed their corporate profit tax rates and have also been enticed to liberalize their labor markets. Now, they will also learn fiscal policy from the east. Rather than being the laggards, the East Europeans will be the leaders in economic policymaking.

All this amounts to convergence rather than divergence. Thus the title of this book: *The Last Shall Be the First*.[23]

23. I owe this title to a suggestion from my colleague Adam S. Posen.

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